



Annual Report and Accounts 2010

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Board of directors and secretary

Chairman

Philip Hampton
N (Chairman)

Executive directors

Stephen Hester
Bruce Van Saun

Non-executive directors

Colin Buchan*
A, N, Ri

Sandy Crombie*
Senior Independent Director
N, R, Ri

Penny Hughes*
N, R (Chair)

Joe MacHale*
N, Ri

John McFarlane*
N, R

Brendan Nelson*
A (Chairman), N, Ri

Arthur 'Art' Ryan*
N

Philip Scott*
A, N, Ri (Chairman)

Secretary

Aileen Taylor

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

Auditors

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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', 'RBS plc' or 'the Bank') is a wholly-owned subsidiary of The Royal Bank of Scotland Group plc ('RBSG' or '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 owned 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%.

During the year, the holding company converted certain non-cumulative preference shares into ordinary shares in the holding company. As a result, HM Treasury's holding in the holding company's ordinary shares reduced to 67.8% and its economic interest reduced to 82.8%.

Organisational structure and business overview

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

UK Retail offers a comprehensive range of banking products and related financial services to the personal market. It serves customers through the RBS and NatWest networks of branches and ATMs in the United Kingdom, and also through telephone and internet channels. UK Retail launched the Retail Customer Charter in June 2010 and progress against the commitments made are formally reported every six months.

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

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

Global Transaction Services (GTS) 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.

Ulster Bank is the leading retail and business bank in Northern Ireland and the third largest banking group on the island of Ireland. It provides a comprehensive range of financial services. The Retail Markets division, which has a network of 236 branches, operates in the personal and financial planning sectors. The Corporate Markets division 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.

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

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 and mortgage markets and portfolio management and origination.

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, 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.

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

Business divestments

To comply with European Commission (EC) state aid requirements the RBS Group has agreed a series of restructuring measures to be implemented over a four year period from December 2009. This will supplement the measures in the strategic plan previously announced by the RBS Group. These include divesting RBS Insurance, 80.01% of Global Merchant Services and substantially all of Sempra Commodities J.V. business as well as divesting the RBS branch-based business in England and 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. Banks' balance sheets have strengthened whilst loan demand has been subdued as many customers have sought to de-lever and the UK economy has proved slow to recover. Competition for retail deposits remains intense as institutions continue to target strong and diverse funding platforms for their balance sheets.

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 clearing banks, building societies and major retailers. In the mortgage market, the Group competes with UK clearing banks and building societies. The ambitions of non-traditional players in the UK market remain strong with retailers and new entrants forming aggressive expansion plans.

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. The challenging conditions in the Irish economy persist and many of the domestic Irish banks have required State support and are engaged in significant restructuring actions.

In the United States, Citizens competes in the New England, Mid-Atlantic and Mid-West retail and mid-corporate banking markets with local and regional banks and other financial institutions. The Group also competes in the US in large corporate lending and specialised finance markets, and in fixed-income trading and sales. Competition is principally with the large US commercial and investment banks and international banks active in the US. The economic recovery in the US is proving weaker than expected and loan demand is weak in Citizens' markets which in turn has dampened the level of competitive pressure in the deposit markets as funding pressures have eased.

Risk factors

Set out below is a summary of certain risks which could adversely affect the Group. These should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties. A fuller description of these and other risk factors is included on pages 238 to 254.

- RBSG or any of its UK bank subsidiaries may face the risk of full nationalisation or other resolution procedures and various actions could be taken by or on behalf of the UK Government, including actions in relation to any securities issued, new or existing contractual arrangements and transfers of part or all of RBSG's businesses.
- The RBS Group's ability to implement its strategic plan depends on the success of its efforts to refocus on its core strengths and its balance sheet reduction programme. As part of the RBS Group's strategic plan and implementation of the State Aid restructuring plan agreed with the EC and HM Treasury, the RBS Group is undertaking an extensive restructuring which may adversely affect the Group's business, results of operations and financial condition and give rise to increased operational risk and may impair the RBS Group's ability to raise new Tier 1 capital due to restrictions on its ability to make discretionary dividend or coupon payments on certain securities.
- The Group's businesses, earnings and financial condition have been and will continue to be affected by geopolitical conditions, the global economy, the instability in the global financial markets and increased competition. These have resulted in significant changes in market conditions including interest rates, foreign exchange rates, credit spreads, and other market factors and consequent changes in asset valuations.
- The Group requires access to sources of liquidity, which have been constrained in recent years, and a failure to access liquidity due to market conditions or otherwise could adversely affect the Group's financial condition. In addition, the Group's borrowing costs and its access to the debt capital markets and other sources of liquidity depend significantly on its and the UK Government's credit ratings.
- The actual or perceived failure or worsening credit of the Group's counterparties (including monolines or other credit insurers) or borrowers and depressed asset valuations resulting from poor market conditions have adversely affected and could continue to adversely affect the Group.
- The value of certain financial instruments recorded at fair value is determined using financial models incorporating assumptions, judgements and estimates that may change over time or may ultimately not turn out to be accurate.
- The Group's business performance, financial condition and capital and liquidity ratios could be adversely affected if its capital is not managed effectively or as a result of changes to capital adequacy and liquidity requirements, including those arising out of Basel III implementation (globally or by UK authorities), or if the RBS Group is unable to issue Contingent B Shares to HM Treasury under certain circumstances.
- The 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.
- Any significant developments in regulatory or tax legislation could have an effect on how the Group conducts its business and on its results of operations and financial condition, and the recoverability of certain deferred tax assets recognised by the Group is subject to uncertainty.
- The Group is subject to substantial regulation and oversight, and any significant regulatory or legal developments could have an adverse effect on how the Group conducts its business and on its results of operations and financial condition. In addition, the Group is and may be subject to litigation and regulatory investigations that may impact its business, results of operations and financial condition.
- Operational and reputational risks are inherent in the Group's operations.
- The Group may be required to make contributions to its pension schemes and government compensation schemes, either of which may have an adverse impact on the Group's results of operations, cash flow and financial condition.
- As a result of the UK Government's majority shareholding in the RBS Group they can, and in the future may decide, to exercise a significant degree of influence over the Group including suspending dividends and certain coupon payments, modifying or cancelling contracts or limiting the Group's operations. The offer or sale by the UK Government of all or a portion of its shareholding in RBSG could affect the market price of the equity shares and other securities and acquisitions of ordinary shares by the UK Government (including through conversions of other securities or further purchases of shares) may result in the delisting of RBSG from the Official List.
- The Group's participation in the APS is costly and complex and may not produce the benefits expected and the occurrence of associated risks may have a material adverse impact on the Group's business, capital or tax position, financial condition and results of operations. Any changes to the regulatory treatment of the APS may negatively impact the Group's capital position and any withdrawal from, or termination of, the APS will be costly.

Financial summary

Summary consolidated income statement for the year ended 31 December 2010

	2010 £m	2009 £m
Net interest income	12,111	11,543
Fees and commissions receivable	7,591	7,734
Fees and commissions payable	(2,060)	(1,972)
Income from trading activities	3,361	3,007
Gain on redemption of own debt	502	2,694
Other operating income	2,199	1,537
Non-interest income	11,593	13,000
Total income	23,704	24,543
Operating expenses	(14,475)	(12,372)
Profit before impairment losses	9,229	12,171
Impairment losses	(9,400)	(12,174)
Operating loss before tax	(171)	(3)
Tax (charge)/credit	(713)	523
(Loss)/profit for the year	(884)	520
Non-controlling interests	(29)	(235)
Preference dividends	(60)	(523)
Loss attributable to ordinary shareholders	(973)	(238)

Operating loss

Operating loss before tax was £171 million compared with £3 million in 2009. Lower gains on redemption of own debt, the movement in the fair value of the Asset Protection Scheme (APS) credit default swap and pension curtailment gains recognised in 2009 were largely offset by an increase in operating income, gains on strategic disposals, good control of expenses and lower impairment losses.

Total income

Total income was down 3% to £23,704 million, primarily due to lower gains on redemption of own debt and the movement in the fair value of the APS credit default swap partially offset by gains on strategic disposals.

Net interest income

Net interest income increased by 5% to £12,111 million primarily reflecting improvements in net interest margin which more than offset lower interest-earning assets and interest-bearing liabilities.

Non-interest income

Non-interest income decreased to £11,593 million from £13,000 million in 2009 largely reflecting significantly lower gains on redemption of own debt of £502 million from £2,694 million in 2009 and the movement in the fair value of the APS credit default swap. This was partially offset by an increase in other operating income, income from trading activities and gains on strategic disposals.

Operating expenses

Operating expenses were £14,475 million compared with £12,372 million in 2009, which benefitted from pension curtailment gains of £2,148 million. Adjusting for pension curtailment gains, operating expenses were flat. Integration and restructuring costs at £825 million were down £34 million, 4% from £859 million in 2009.

Cost:income ratio

The Group's cost:income ratio was 61.1% compared with 50.4% in 2009. Excluding the gain on redemption of own debt in both years, the movement in the APS credit default swap and pension curtailment gains in 2009, the cost:income ratio was 58.5% compared with 66.5% in 2009.

Impairment losses

Impairment losses were £9,400 million, compared with £12,174 million in 2009, with Core bank impairments falling by £399 million and Non-Core by £2,375 million. Impairments fell in all businesses, except Ulster Bank, which has faced an economic environment that remains challenging.

Capital ratios

Capital ratios at 31 December 2010 were 8.4% (Core Tier 1), 10.1% (Tier 1) and 13.6% (Total).

Divisional performance

The results of each division are set out below. The results are stated before fair value of own debt, amortisation of purchased intangible assets, integration and restructuring costs, gain on redemption of own debt, strategic disposals, gains on pensions curtailment, bonus tax, Asset Protection Scheme credit default swap - fair value changes 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.

	2010 £m	2009 £m
UK Retail	1,476	420
UK Corporate	1,581	1,164
Wealth	287	358
Global Transaction Services	864	831
Ulster Bank	(624)	(281)
US Retail & Commercial	427	94
Retail & Commercial	4,011	2,586
Global Banking & Markets	3,235	5,559
Central items	(1,309)	(1,829)
Core	5,937	6,316
Non-Core	(4,735)	(9,654)
Operating profit/(loss)	1,202	(3,338)
Fair value of own debt	(31)	(298)
Amortisation of purchased intangible assets	(63)	(81)
Integration and restructuring costs	(825)	(859)
Gain on redemption of own debt	502	2,694
Strategic disposals	645	—
Gains on pensions curtailment	—	2,148
Bonus tax	(50)	(151)
Asset Protection Scheme credit default swap - fair value changes	(1,550)	—
Write-down of goodwill and other intangible assets	(1)	(118)
Loss before tax	(171)	(3)

The performance of each division is reviewed on pages 8 to 17.

UK Retail

	2010 £m	2009 £m
Net interest income	4,082	3,535
Net fees and commissions	1,120	1,285
Other non-interest income	(1)	4
Non-interest income	1,119	1,289
Total income	5,201	4,824
Direct expenses		
- staff costs	(720)	(784)
- other	(402)	(362)
Indirect expenses	(1,443)	(1,579)
	(2,565)	(2,725)
Operating profit before impairment losses	2,636	2,099
Impairment losses	(1,160)	(1,679)
Operating profit	1,476	420
	£bn	£bn
Balance sheet		
Loans and advances to customers (gross)		
- mortgages	90.6	83.2
- personal	11.7	13.6
- cards	6.1	6.2
	108.4	103.0
Customer deposits	99.3	87.2
Assets under management (excluding deposits)	5.7	5.3

The development of the RBS and NatWest Customer Charters aims to deliver those elements that customers have said are most important to them, and has been well received by both customers and staff. The division is reaping continuing benefits from investment in process improvements and automation, resulting in gains in both service quality and cost efficiency.

Serving our customers better is a key priority for RBS. While our customer satisfaction compares well with our competitors we know we can do more. In June 2010 we launched a Customer Charter setting out 14 commitments to delivering helpful banking.

The Customer Charter reflects the views and expectations of more than 30,000 customers. We are working hard to deliver on the commitments we have made. This won't happen overnight but the Customer Charter is our pledge that we will be regularly held to account against the progress we make. As part of this we will publish an independently-assured report on our performance every six months.

2010 compared with 2009

Operating profit recovered strongly from the low levels recorded in 2009 to £1,476 million. Profit before impairments was up £537 million or 26% and impairments fell by £519 million as the economic environment continued to recover.

The division has continued to focus in 2010 on growing secured lending while at the same time building customer deposits, thereby reducing the Group's reliance on wholesale funding. Loans and advances to customers grew 5%, with a change in mix from unsecured to secured as the Group actively sought to improve its risk profile. Mortgage balances grew by 9% while unsecured lending contracted by 10%.

- Mortgage growth was due to good retention of existing customers and new business, the majority of which comes from the existing customer base. Gross mortgage lending market share remained broadly in line with 2009 at 12%, with the RBS Group on track to meet its Government target on net mortgage lending.
- Customer deposits grew 14% on 2009, reflecting the strength of the UK Retail customer franchise, which outperformed the market in an increasingly competitive environment. Savings balances grew by £8 billion or 13% with 1.8 million accounts opened, outperforming the market total deposit growth of 3%. Personal current account balances increased by 3% on 2009.

Net interest income increased by 15% to £4,082 million, driven by strong balance sheet growth and improvement in net interest margin.

Non-interest income declined by 13% to £1,119 million, principally reflecting the restructuring of current account overdraft fees in the final quarter of 2009.

Expenses decreased by 6%, with the cost:income ratio improving from 56.5% to 49.3%.

- Direct staff costs declined by 8%, largely driven by a clear management focus on process re-engineering enabling a 7% reduction in headcount.
- RBS continues to progress towards a more convenient, lower cost operating model, with over 4.8 million active users of online banking and a record share of new sales achieved through direct channels. More than 7.8 million accounts have switched to paperless statements and 276 branches now utilise automated cash deposit machines.

Impairment losses decreased by 31% to £1,160 million primarily reflecting the recovery in the economic environment.

- The mortgage impairment charge was £177 million (2009 - £124 million) on a total book of £91 billion. Mortgage arrears rates marginally increased in 2010 but remain below the industry average, as reported by the Council of Mortgage Lenders. Repossessions showed only a small increase on 2009, as the Group continues to support customers facing financial difficulties.
- The unsecured lending impairment charge was £983 million (2009 - £1,555 million) on a total book of £18 billion.

UK Corporate

	2010 £m	2009 £m
Net interest income	2,584	2,249
Net fees and commissions	951	857
Other non-interest income	372	433
Non-interest income	1,323	1,290
Total income	3,907	3,539
Direct expenses		
- staff costs	(777)	(753)
- other	(359)	(260)
Indirect expenses	(429)	(435)
	(1,565)	(1,448)
Operating profit before impairment losses	2,342	2,091
Impairment losses	(761)	(927)
Operating profit	1,581	1,164
	£bn	£bn
Balance sheet		
Loans and advances to customers (gross)	111.5	111.3
Customer deposits	100.0	87.8

2010 compared with 2009

Operating profit grew by £417 million, 36%, compared with 2009, driven by strong income growth and significantly lower impairments, partially offset by higher costs.

UK Corporate performed strongly in the deposit market, with customer deposit balance growth of £12.2 billion contributing to a 15 percentage point improvement in the loan to deposit ratio in 2010. While customer lending increased only marginally (with gross lending largely offset by customer deleveraging), net interest income rose by £335 million, 15%, driven primarily by the good progress made on loan repricing.

Non-interest income increased by 3% reflecting strong refinancing levels and increased operating lease activity, partially offset by lower sales of financial market products.

Total costs increased by 8% (£117 million) or 6% excluding the OFT penalty in 2010, legal recovery in 2009 and the normalisation of staff compensation phasing.

Impairments were 18% lower, primarily as a result of higher charges taken during the first half of 2009 to reflect potential losses in the portfolio not yet specifically identified.

Wealth

	2010 £m	2009 £m
Net interest income	554	564
Net fees and commissions	374	362
Other non-interest income	71	83
Non-interest income	445	445
Total income	999	1,009
Direct expenses		
- staff costs	(379)	(353)
- other	(142)	(144)
Indirect expenses	(173)	(121)
	(694)	(618)
Operating profit before impairment losses	305	391
Impairment losses	(18)	(33)
Operating profit	287	358
	£bn	£bn
Balance sheet		
Loans and advances to customers (gross)		
- mortgages	7.8	6.5
- personal	6.7	4.9
- other	1.6	2.3
	16.1	13.7
Customer deposits	36.5	35.7
Assets under management (excluding deposits)	32.1	30.7

2010 compared with 2009

2010 operating profit fell by 20% driven by lower net interest income and higher expenses, partly offset by a 45% decline in impairments in the year.

Income declined by £10 million primarily due to lower net interest income. Strong lending and investment income was offset by the impact of a competitive deposit market.

Expenses grew by 12% to £694 million. Direct expenses were up 5%, £24 million, reflecting additional strategic investment. Indirect expenses increased by £52 million reflecting a change in allocation of Business Services costs.

Assets under management grew by 5% largely through improving market conditions. On a constant currency basis, assets fell 2% with valuation gains being offset by client losses in the international businesses, resulting from the private banker attrition previously experienced.

Global Transaction Services

	2010 £m	2009 £m
Net interest income	421	447
Non-interest income	1,325	1,292
Total income	1,746	1,739
Direct expenses		
- staff costs	(287)	(277)
- other	(123)	(127)
Indirect expenses	(458)	(488)
	(868)	(892)
Operating profit before impairment losses	878	847
Impairment losses	(14)	(16)
Operating profit	864	831
	£bn	£bn
Balance sheet		
Total third party assets	14.7	10.3
Loans and advances	6.8	6.4
Customer deposits	41.0	38.5

2010 compared with 2009

Operating profit increased 4%, driven by a robust income performance (which has more than compensated for the loss of Global Merchant Services (GMS) income), good cost control and lower impairments. Adjusting for the disposal operating profit increased 14%.

For the eleven months before disposal, GTS booked income of £442 million and total expenses of £244 million for GMS, generating an operating profit of £198 million.

Income was up £7 million, or £63 million excluding GMS, reflecting higher deposit volumes in the International Cash Management business, strong growth in the Trade Finance business and improved Commercial Card transaction volumes, offset by a decline in the UK and US Domestic Cash Management businesses due to margin compression.

Expenses decreased by 3% from 2009, to £868 million, as increased investment in front office and support infrastructure was mitigated by tight management of business costs.

Third party assets increased by £4.4 billion, or £5.2 billion excluding GMS, as Yen clearing activities were brought in-house and loans and advances increased.

Ulster Bank

	2010 £m	2009 £m
Net interest income	860	829
Net fees and commissions	156	228
Other non-interest income	58	26
Non-interest income	214	254
Total income	1,074	1,083
Direct expenses		
- staff costs	(237)	(325)
- other	(74)	(86)
Indirect expenses	(226)	(304)
	(537)	(715)
Operating profit before impairment losses	537	368
Impairment losses	(1,161)	(649)
Operating loss	(624)	(281)
	£bn	£bn
Balance sheet		
Loans and advances to customers (gross)		
- mortgages	21.2	16.2
- corporate		
- property	5.4	10.1
- other corporate	9.0	11.0
- other lending	1.3	2.4
	36.9	39.7
Customer deposits	23.1	21.9

2010 compared with 2009

Overall performance deteriorated in 2010, largely as a result of an increase in impairment losses of £512 million. Operating profit before impairment losses increased to £537 million, up 46%, driven by the culmination of a bank-wide cost saving programme during 2010.

Net interest income increased by 4% as actions to increase asset margins were partially eroded by tightening deposit margins due to intensive market competition.

Non-interest income was 16% lower primarily reflecting a non-recurring gain in Q4 2009.

Loans to customers fell by 7% to £36.9 billion. On 1 July 2010 the division transferred a portfolio of development property assets to the Non-Core division, partially offset by a simultaneous transfer of a portfolio of retail mortgage assets to the core business.

Despite intense competition, customer deposit balances increased by 5% over the year with strong growth across all deposit categories, driven by a focus on improving the bank's funding profile.

Expenses were 25% lower at £537 million. The strong year-on-year performance in expenses was primarily driven by an increased focus on active management of the cost base, and the benefits derived from the business restructuring and cost-saving programme which commenced in 2009.

Impairment losses increased by £512 million to £1,161 million reflecting the deteriorating economic environment in Ireland and rising default levels across both personal and corporate portfolios. Lower asset values, particularly in property-related lending together with pressure on borrowers with a dependence on consumer spending have resulted in higher corporate loan losses, while higher unemployment, lower incomes and increased taxation have driven mortgage impairment increases.

Customer numbers increased by 3% during 2010, with a strong performance in current and savings accounts switchers.

Financial review continued

US Retail & Commercial

	2010 US\$m	2009 US\$m	2010 £m	2009 £m
Net interest income	3,010	2,985	1,948	1,907
Net fees and commissions	1,126	1,119	729	714
Other non-interest income	465	368	300	235
Non-interest income	1,591	1,487	1,029	949
Total income	4,601	4,472	2,977	2,856
Direct expenses				
- staff costs	(1,212)	(1,214)	(784)	(776)
- other	(880)	(929)	(569)	(593)
Indirect expenses	(1,050)	(1,079)	(680)	(691)
	(3,142)	(3,222)	(2,033)	(2,060)
Operating profit before impairment losses	1,459	1,250	944	796
Impairment losses	(799)	(1,099)	(517)	(702)
Operating profit	660	151	427	94
Average exchange rate - US\$/£			1.546	1.566
	US\$bn	US\$bn	£bn	£bn
Balance sheet				
Loans and advances to customers (gross)				
- residential mortgages	9.4	10.6	6.1	6.5
- home equity	23.6	25.0	15.2	15.4
- corporate and commercial	31.7	31.6	20.4	19.5
- other consumer	10.6	12.1	6.9	7.5
	75.3	79.3	48.6	48.9
Customer deposits (excluding repos)	91.2	97.4	58.7	60.1
Spot exchange rate - US\$/£			1.552	1.622

2010 compared with 2009

Operating profit of \$660 million represented a marked improvement from a profit of \$151 million with income up 3%, expenses down 2% and impairment losses down 27%.

Net interest income was up \$25 million, despite a smaller balance sheet.

Non-interest income was up 7% reflecting higher mortgage banking and debit card income, commercial banking fees and higher gains on securities realisations. This was partially offset by lower deposit fees which were impacted by Regulation E legislative changes in 2010. In addition, gains of \$330 million were recognised on the sale of available-for-sale securities as part of the balance sheet restructuring exercise, but these were almost wholly offset by losses crystallised on the termination of swaps hedging fixed-rate funding.

Total expenses were down 2%, reflecting a \$113 million credit related to changes to the defined benefit pension plan, and lower Federal Deposit Insurance Corporation (FDIC) deposit insurance levies, partially offset by the impact of changing rates on the valuation of mortgage servicing rights and litigation costs.

Impairment losses declined 27%, following significant loan reserve building in 2009 and a gradual improvement in the underlying credit environment, offset by higher impairments related to securities. Loan impairments as a proportion of loans and advances decreased from 1.4% to 1.0%.

Global Banking & Markets

	2010 £m	2009 £m
Net interest income	901	1,088
Net fees and commissions	961	891
Income from trading activities	4,307	6,451
Other operating income	251	(66)
Non-interest income	5,519	7,276
Total income	6,420	8,364
Direct expenses		
- staff costs	(1,983)	(1,849)
- other	(498)	(376)
Indirect expenses	(415)	(263)
	(2,896)	(2,488)
Operating profit before impairment losses	3,524	5,876
Impairment losses	(289)	(317)
Operating profit before fair value of own debt	3,235	5,559
Fair value of own debt	(75)	(193)
Operating profit	3,160	5,366
	£bn	£bn
Balance sheet		
Loans and advances to customers	59.5	64.6
Loans and advances to banks	38.8	30.2
Reverse repos	89.9	63.8
Securities	88.8	86.1
Cash and eligible bills	29.2	46.4
Other	12.7	18.6
Total third party assets (excluding derivatives mark-to-market)	318.9	309.7
Customer deposits (excluding repos)	36.2	51.9

2010 compared with 2009

A fall in operating profit of 42% year on year reflects sharply reduced income and increased costs, which were partially offset by an improvement in impairments.

Total income was £1,944 million lower in 2010 driven by increased risk aversion in the market during the second half of 2010, combined with the non-repeat of favourable market conditions seen in the first half of 2009.

- Higher revenue across the Rates and Currencies businesses during 2009 was driven by rapidly falling interest rates and wide bid-offer spreads generating exceptional revenue opportunities, which have not been repeated in 2010.
- The Credit Markets business remained broadly flat, supported by strong Mortgage Trading income where customer demand remained buoyant during 2010.

- Increased revenue from Portfolio Management was driven by disciplined lending alongside a reduction in balance sheet management activities and associated costs.

Expenses increased by 16% to £2,896 million. This was largely driven by an increase in staff costs of £134 million and an increase in indirect expenses of £152 million.

The low level of impairments in 2010 reflected a small number of specific cases partially offset by an improved picture on latent loss provisions. This contrasted with 2009, which witnessed a significantly higher level of specific impairments.

Central items

	2010 £m	2009 £m
Central items not allocated before fair value of own debt	(1,309)	(1,829)
Fair value of own debt	44	(105)
Central items not allocated	<u>(1,265)</u>	<u>(1,934)</u>

Note:

(1) Costs/charges are denoted by brackets.

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

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

2010 compared with 2009

Central items not allocated before fair value of own debt amounted to a net debit of £1,309 million, a decrease of £520 million compared with 2009. The decrease primarily relates to a one-off VAT recovery in 2010 of £170 million, dividends received from fellow subsidiaries of £124 million and an increase in net management fees received of £55 million.

The Group's credit spreads have fluctuated over the course of the year but ended the year slightly tighter, resulting in an overall annual decrease in the carrying value of own debt.

Non-Core

	2010 £m	2009 £m
Net interest income	1,611	1,865
Net fees and commissions	243	386
Loss from trading activities	(55)	(3,603)
Other operating income	473	935
Non-interest income	661	(2,282)
Total income	2,272	(417)
Direct expenses		
- staff costs	(563)	(579)
- other	(812)	(710)
Indirect expenses	(156)	(97)
	(1,531)	(1,386)
Operating profit/(loss) before impairment losses	741	(1,803)
Impairment losses	(5,476)	(7,851)
Operating loss	(4,735)	(9,654)
	£bn	£bn
Balance sheet		
Total third party assets (excluding derivatives)	122.4	171.2
Total third party assets (including derivatives)	139.1	191.7
Loans and advances to customers (gross)	98.6	127.8
Customer deposits	1.6	6.0

2010 compared with 2009

By the end of 2010 third party assets (excluding derivatives) had decreased to £122.4 billion as a result of a successful disposal strategy, managed portfolio run-off and impairments.

2010 operating losses in Non-Core were 51% lower than those recorded in 2009. The improvement in performance was driven by significantly lower trading losses and a marked decline in impairments.

Losses from trading activities declined from £3,603 million for 2009 to £55 million for 2010 as underlying asset prices recovered, offset by continuing weakness in credit spreads. The division has recorded profits on the disposal of many asset-backed securities positions. In addition, a

significantly smaller loss was recorded on banking book hedges as spreads tightened, compared with 2009.

Staff expenses fell by 3% over the year, largely driven by the impact of business divestments, including a number of country exits and the disposal of substantially all of the Group's interest in the RBS Sempra Commodities JV.

Impairments were £2,375 million lower than 2009. The decline reflects the overall improvement in the economic environment, although still high loss rates reflect the difficult conditions experienced in specific sectors, including both UK and Irish commercial property sectors.

Financial review continued

Consolidated balance sheet at 31 December 2010

	2010 £m	2009 £m
Assets		
Cash and balances at central banks	49,838	27,060
Net loans and advances to banks	46,975	37,611
Reverse repurchase agreements and stock borrowing	40,530	30,830
Loans and advances to banks	87,505	68,441
Net loans and advances to customers	469,161	502,357
Reverse repurchase agreements and stock borrowing	49,160	33,812
Loans and advances to customers	518,321	536,169
Debt securities	166,029	185,181
Equity shares	2,340	2,405
Settlement balances	8,748	9,153
Derivatives	429,005	446,353
Intangible assets	11,832	11,814
Property, plant and equipment	16,143	17,309
Deferred tax	1,790	2,228
Prepayments, accrued income and other assets	6,237	12,665
Assets of disposal groups	9,542	14,203
Total assets	1,307,330	1,332,981
Liabilities		
Bank deposits	56,626	80,556
Repurchase agreements and stock lending	28,594	35,582
Deposits by banks	85,220	116,138
Customer deposits	394,559	387,277
Repurchase agreements and stock lending	77,766	66,025
Customer accounts	472,325	453,302
Debt securities in issue	164,662	172,413
Settlement balances	8,501	7,922
Short positions	41,130	36,472
Derivatives	420,969	424,544
Accruals, deferred income and other liabilities	13,734	16,474
Retirement benefit liabilities	2,229	2,622
Deferred tax	1,422	1,187
Subordinated liabilities	32,023	34,717
Liabilities of disposal groups	7,508	10,993
Total liabilities	1,249,723	1,276,784
Non-controlling interests	597	1,146
Owners' equity	57,010	55,051
Total equity	57,607	56,197
Total liabilities and equity	1,307,330	1,332,981

Commentary on consolidated balance sheet

Total assets of £1,307.3 billion at 31 December 2010 were down £25.7 billion, 2%, compared with 31 December 2009. This principally reflects the continuing planned disposal of Non-Core assets, together with a reduction in the level of debt securities and the mark-to-market value of derivatives.

Cash and balances at central banks were up £22.8 billion, 84%, to £49.8 billion principally due to an improvement in the Group's structural liquidity position during 2010.

Loans and advances to banks increased by £19.1 billion, 28%, to £87.5 billion reflecting higher reverse repurchase agreements and stock borrowing ('reverse repos'), up by £9.7 billion, 31% to £40.5 billion and higher bank placings, up £9.4 billion, 25%, to £47.0 billion, primarily as a result of the investment of surplus liquidity in short-term assets.

Loans and advances to customers were down £17.8 billion, 3%, at £518.3 billion. Within this, reverse repos increased by 45%, £15.3 billion to £49.2 billion. Excluding reverse repos, lending decreased by £33.1 billion, 7% to £469.1 billion. This was primarily driven by planned reductions in Non-Core along with declines in Global Banking & Markets, Ulster Bank and US Retail & Commercial, offset in part by growth in UK Retail, Wealth and Global Transaction Services, together with the effect of exchange rate and other movements.

Debt securities decreased by £19.2 billion, 10%, to £166.0 billion, driven mainly by lower holdings in Global Banking & Markets and Non-Core.

The value of derivative assets were down £17.3 billion, 4%, to £429.0 billion, primarily reflecting a decrease in interest contracts, movements in five to ten year interest yields, and the combined effect of currency movements, with Sterling weakening against the US dollar but strengthening against the Euro.

Decreases in assets and liabilities of disposal groups resulted mainly from the disposal of substantially all of the RBS Sempra Commodities joint venture business.

Deposits by banks declined by £30.9 billion, 27% to £85.2 billion due to reduced inter-bank deposits, down £23.9 billion, 30% to £56.6 billion and lower repurchase agreements and stock lending ('repos'), down £7.0 billion, 20%, to £28.6 billion.

Customer accounts increased by £19.0 billion, 4%, to £472.3 billion. Within this, repos increased £11.7 billion, 18% to £77.8 billion. Excluding repos, deposits were up by £7.3 billion, 2%, to £394.5 billion, reflecting growth in UK Retail, Wealth, Ulster Bank, UK Corporate and Global Transaction Services, partially offset by decreases in Global Banking & Markets, US Retail & Commercial and Non-Core.

Debt securities in issue were down £7.8 billion, 4% to £164.7 billion. Reductions in the level of certificates of deposit and commercial paper in Global Banking & Markets were partially offset by a programme of new term issuances.

Subordinated liabilities were down £2.7 billion, 8% to £32.0 billion, reflecting the redemption of £2.4 billion undated loan capital and debt preference shares under the liability management exercise completed in May 2010, together with the redemption of £0.9 billion dated loan capital, offset in part by the effect of exchange rate movements and other adjustments of £0.6 billion.

Owners' equity increased by £2.0 billion, 4%, to £57.0 billion. This was driven by an increase in available-for-sale reserves, £1.1 billion, capital contributions from the holding company of £1.0 billion, and exchange rate and other movements, £0.8 billion, partially offset by the attributable loss for the year of £0.9 billion.

Cash flow

	2010 £m	2009 £m
Net cash flows from operating activities	32,992	15,144
Net cash flows from investing activities	3,971	(8,550)
Net cash flows from financing activities	(1,480)	10,697
Effects of exchange rate changes on cash and cash equivalents	756	(4,767)
Net increase in cash and cash equivalents	<u>36,239</u>	<u>12,524</u>

2010

The major factors contributing to the net cash inflow from operating activities of £32,992 million were the increase of £29,919 million in operating liabilities less operating assets, other non cash items, £3,806 million, depreciation and amortisation, £1,689 million and interest on subordinated liabilities, £816 million. This was partly offset by the elimination of foreign exchange difference of £3,107 million.

Net cash inflows from investing activities of £3,971 million relate to the net inflows from sales and maturities of securities of £1,400 million and net investments in business interests and intangible assets of £2,607 million.

Net cash outflows from financing activities of £1,480 million primarily arose from the redemption of non-controlling interests of £549 million, dividends paid of £214 million, repayment of subordinated liabilities of £880 million and interest paid on subordinated liabilities of £895 million. This was offset in part by a capital contribution of £1,000 million.

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.

Risk and balance sheet management

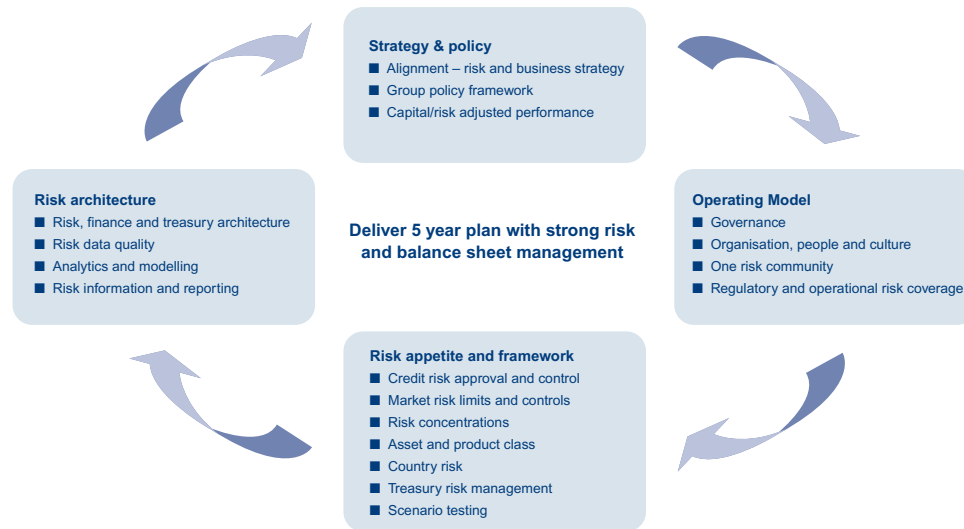
In this section (pages 21 to 119) of the Financial review certain information has been audited and is part of the Group’s financial statements as permitted by IFRS 7. Other disclosures are unaudited and labelled with an asterisk (*).

Risk and balance sheet management are conducted on an overall basis within the RBS Group such that common policies, procedures, frameworks and models apply across the RBS Group. Therefore, for the most part, discussions on these aspects reflect those in the RBS Group as relevant for businesses and operations in the Group. Data is provided for the Bank and its subsidiaries (‘the Group’), as well as the Bank.

Introduction*

All the disclosures in this section (pages 21 to 26) are unaudited as indicated by an asterisk (*).

Risk Management has an integral role to play in the delivery of the strategic plan through the creation and management of appropriate frameworks as illustrated below:



With the need for financial strength and resilience at the heart of this and in order to support the RBS Group’s stated objective of standalone strength by 2013 the RBS Group Board agreed in 2009 the key strategic risk objectives which are aligned to all other elements of the plan. These are:

- maintain capital adequacy;
- maintain market confidence;
- deliver stable earnings growth; and
- stable and efficient access to funding and liquidity.

These strategic risk objectives are the bridge between the RBS Group level business strategy and the frameworks, measures and metrics which are used to set appetite and manage risk in the business divisions. The risk appetite framework is aligned with business objectives, with underlying and cascading frameworks and limits, which are described in this section. Enhancements have been made through the year and are ongoing.

Risk appetite

Risk appetite is an expression of the level of risk that the RBS Group is prepared to accept to deliver its business objectives. Risk and balance sheet management across the RBS Group is based on the risk appetite approved by the RBS Group Board, who will agree targets for each division and regularly review and monitor the Group’s performance in relation to risk.

Risk appetite is defined in both quantitative and qualitative terms and serves as a way of tracking Risk Management performance in implementing the agreed strategy.

- quantitative: encompassing scenario stress testing, risk concentrations, VaR, liquidity and credit related metrics; operational, business risk and regulatory measures.
- qualitative: ensuring that the RBS Group applies the correct principles, policies and procedures, manages reputational risk and develops risk control and culture.

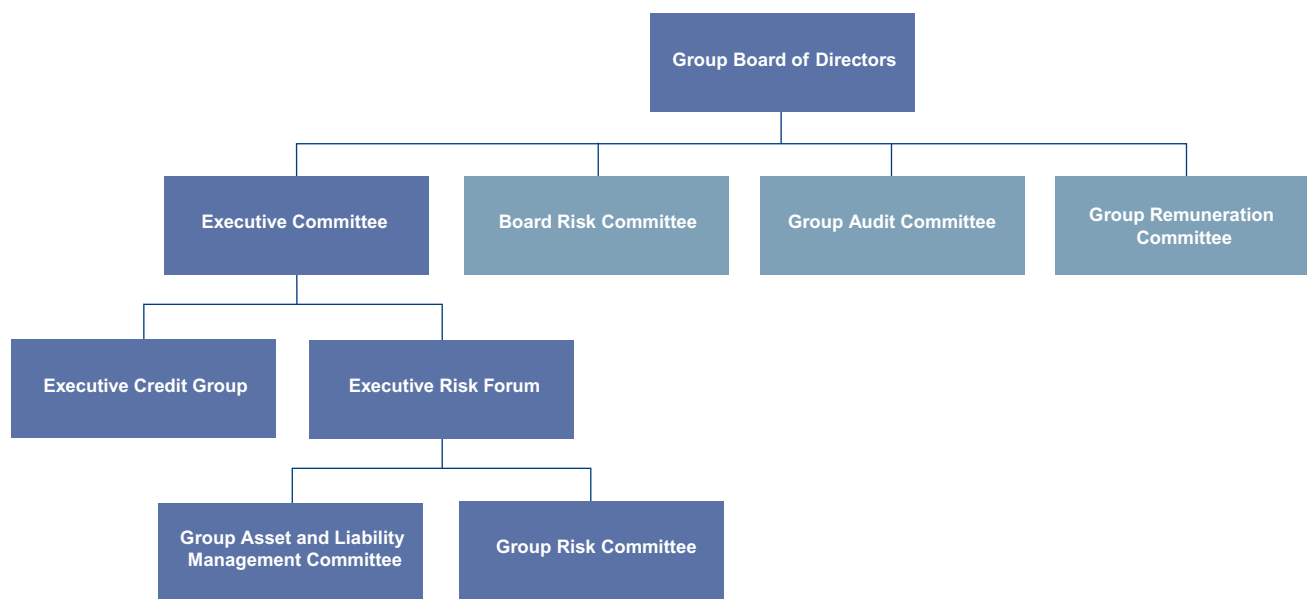
A key part of the RBS Group’s risk appetite is the macro reshaping of the balance sheet through the downsizing of Non-Core. The RBS Group will manage down previous concentrations in line with the strategic objectives for 2013. This will be discharged by Non-Core but with Risk Management playing an integral role in executing the plan. Non-Core assets and their movements are shown separately in the pages which follow.

* unaudited

Introduction* continued

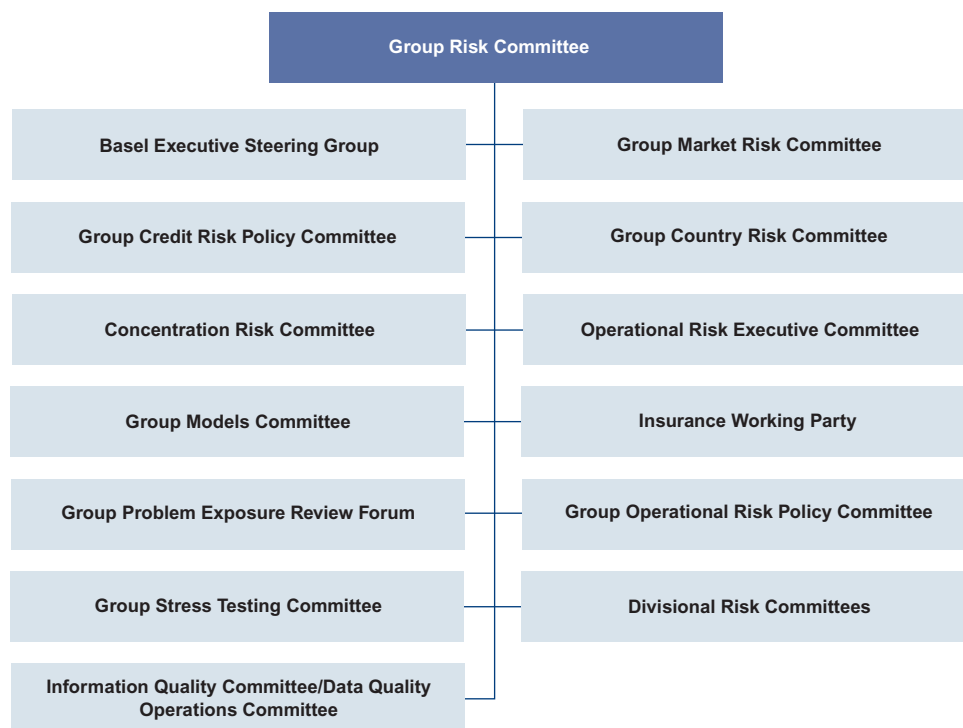
Governance

Risk and balance sheet management strategies are owned and set by the RBS Group's Board of directors, and implemented by executive management led by the RBS 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 the governance structure, with the aim of promoting cross-risk linkages. The roles and responsibilities fulfilled by the key risk committees have been reviewed and more clearly defined during the course of 2010.



■ comprises independent non-executive directors

Shown below are the specialist risk sub-committees that report into the Group Risk Committee.



* unaudited

The role and remit of RBS Group committees is set out below. These committees are supported at a divisional level by a risk governance structure embedded in the businesses. During 2010 Risk Management has been enhanced by the appointment of a Deputy Chief Risk Officer to whom the Divisional CROs and the functional risk heads now report.

Committee	Focus	Membership
Group Board	The Group Board is the main decision making forum at RBS Group level. It ensures that the RBS Group manages risk effectively through approving and monitoring the RBS Group's risk appetite, considering RBS Group stress scenarios and agreed mitigants and identifying longer term strategic threats to the RBS Group's business operations.	The Board of directors
Executive Committee (ExCo)	This committee is responsible for managing RBS Group-wide issues and those operational issues material to the broader RBS Group.	Group Chief Executive Group Finance Director Chief Administrative Officer Chief Executive Officers: US Retail & Commercial and Head of Americas; RBS Insurance; Global Banking & Markets; UK Corporate; and UK Retail, Wealth and Ulster Head of Restructuring and Risk
Board Risk Committee (BRC)	The Board Risk Committee provides oversight and advice to the Group Board in relation to current and potential future risk exposures of the RBS Group and risk strategy, including determination of risk appetite and tolerance. It reviews the performance of the RBS Group relative to risk appetite and provides oversight of the effectiveness of key RBS Group policies, referred to as the Group Policy Framework.	At least three independent non-executive directors, one of whom is the chairman of the Group Audit Committee
Group Audit Committee (GAC)	The Group Audit Committee is responsible for assisting the Group Board in carrying out its responsibilities relating to accounting policies, internal control and financial reporting functions. It assists on such other matters as may be referred to it by the Group Board and acts as the Audit Committee of the Group Board. The Group Audit Committee also identifies any matters within its remit which it considers that action or improvement is needed and makes recommendations as to the steps to be taken.	At least three independent non-executive directors, at least one of whom is a financial expert as defined in the SEC rules under the US Exchange Act
Group Remuneration Committee	The Remuneration Committee is responsible for the overview of the Group's remuneration policy and remuneration governance framework, ensuring that remuneration arrangements are consistent with and promote effective risk management. The committee also makes recommendations to the Board on the remuneration arrangements for executive directors.	At least three independent non-executive directors
Executive Credit Group (ECG)	The ECG decides on requests for the extension of existing or new credit limits on behalf of the Board of directors where the proposed aggregate facility limits are in excess of the credit approval authorities granted to individuals in divisions or in RBS Risk Management, or where an appeal against the decline decision of the Group Chief Credit Officer (or delegates) or Group Chief Risk Officer is referred for final decision.	<p>Group A members</p> Head of Restructuring and Risk Deputy Chief Risk Officer Group Chief Credit Officer/Chief Credit Officer RBS N.V. Head of Global Restructuring Group Chief Risk Officer, Non-Core division (alternate)

Introduction* *continued*
Governance *continued*

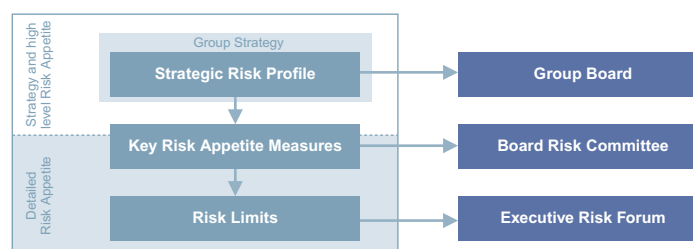
Committee	Focus	Membership
Executive Risk Forum (ERF)	Acts on all strategic risk and control matters across the RBS Group including, but not limited to, credit risk, market risk, operational risk, compliance and regulatory risk, enterprise risk, treasury and liquidity risk, reputational risk, insurance risk and country risk.	Group Chief Executive Head of Restructuring and Risk Deputy Group Chief Risk Officer Group Finance Director Chief Executive from each division
Group Asset and Liability Committee (GALCO)	Identifies, manages and controls RBS Group balance sheet risks.	Group Finance Director Director, Group Finance Head of Restructuring and Risk Chief Executive Officer from each division Group Chief Accountant Group Treasurer Group Head of Capital Management Global Head of Balance Sheet Management, Group Treasury Global Head of Markets Head of Non-Core division
Group Risk Committee (GRC)	Recommends and approves limits, policies, processes and procedures to enable the effective management of risk across the RBS Group.	Head of Restructuring and Risk Deputy Chief Risk Officer Group Chief Credit Officer Global Head of: Market and Insurance Risk; Operational Risk; Country Risk and Firm Wide Risk Director, Group Finance Chief Operating Officer, RBS Risk Management Director, Group Compliance Director, Group Regulatory Affairs Divisional Chief Executive Officers nominees Chief Administrative Officer's nominee for Business Services Divisional Chief Risk Officers Chief Operating Officer, Global Restructuring Group

These committees play a key role in ensuring that the RBS Group's risk appetite is supported by effective risk management through limit approval and setting, monitoring and maintenance, reporting and escalation.

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 Executive Risk Forum is responsible for ensuring that the implementation of strategy and operations are in line with the risk appetite determined by the Group Board with a particular focus on identifying and debating macro risks that could, if not managed effectively, impact adherence to the RBS Group's strategic plan. 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.



* unaudited

Risk coverage

The main risk types facing the Group which are covered by the risk appetite framework and managed by the above committees are shown below:

Risk type	Definition	Features	Key developments in 2010	Risk mitigation
Funding and liquidity risk	The risk that the Group does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost.	<p>Potential to disrupt the business model and stop normal functions of the Group.</p> <p>Potential to fail to meet the supervisory requirements of regulators.</p> <p>Significantly correlates with credit risk losses.</p>	Against a backdrop of further market instability, progress was made in meeting the RBS Group's strategic objectives: reduced reliance on short-term wholesale funding; expanded customer deposit franchise; and increased maturity of term debt issuance.	The Group strengthened the structural integrity of the balance sheet through active management of both asset and liability portfolios including a centrally-managed liquidity portfolio of £125 billion.
Credit risk (including counterparty, country and political risks)	The risk that the Group will incur losses owing to the failure of customers to meet their financial obligations to the Group.	<p>Loss characteristics vary materially across portfolios.</p> <p>Significant correlation between losses and the macroeconomic environment.</p> <p>Concentration risk - potential for large material losses.</p>	Asset quality has broadly stabilised, resulting in total loan impairments 22% lower than in 2009. However, weakness in the Irish economy and falling property values have resulted in the doubling of Ulster Bank Group impairments (Core and Non-Core) in 2010.	Further enhancements were made to the RBS Group's credit risk frameworks as well as the systems and tools that support credit risk management processes. The RBS Group continues to reduce the risk associated with legacy exposures through further reductions in Non-Core assets.
Market risk	The risk that the value of an asset or liability may change as a result of a change in market factors.	<p>Potential for large material losses.</p> <p>Potential for losses due to stress events.</p>	Markets have remained both volatile and uncertain since 2007 resulting in a higher level of market risk, despite a reduction in trading book exposure.	The RBS Group has continued to enhance its market risk management framework and reduced trading and banking book exposures, with asset sales and write-downs within Non-Core and banking book available-for-sale assets in Core.
Operational risk	The risk of loss resulting from inadequate or failed processes, people, systems or from external events.	<p>Frequent small losses.</p> <p>Infrequent material losses.</p>	The level of operational risk remains high due to the scale of structural change occurring across the RBS Group; increased government and regulatory scrutiny; and external threats (e.g. e-crime).	<p>The Group Policy Framework (GPF) supports the risk appetite setting process and underpins the control environment.</p> <p>The three lines of defence model gives assurance that the standards in GPF are being adhered to.</p>

Introduction* *continued*
Risk coverage *continued*

Risk type	Definition	Features	Key developments in 2010	Risk mitigation
Regulatory risk	The risks arising from regulatory changes and enforcement.	Adverse impacts on business/operating models, including increased complexity. Financial costs adapting to changes or from penalties. Reputational damage from enforcement action.	The scale and scope of regulatory change remains at unprecedented levels, particularly in the area of prudential regulation (capital, liquidity, governance and risk management). Increased attention was paid to the treatment of systemically important areas such as recovery and resolution plans, remuneration and capital.	The RBS Group manages regulatory change through active engagement with the FSA, other regulators and governments. The most material risks from new regulations, or changes to existing legislation, are assigned an executive sponsor.
Compliance risk	Risks arising from non-compliance with laws, rules, regulations or other standards applicable to the RBS Group.	Breach or alleged breach could result in public or private censure or fine, could have an adverse impact on the RBS Group's business model (including applicable authorisations and licenses), reputation, results of operations and/or financial condition.	The RBS Group, other global financial institutions and the banking industry have faced increased legal, regulatory and public scrutiny. The RBS Group has continued to engage in discussions with relevant stakeholders, regulators and other governmental and non-governmental bodies, including those in the UK and US, regarding the RBS Group's efforts to satisfy all relevant standards and ensure compliance with applicable existing and prospective laws, rules and regulations.	The RBS Group has continued to review and enhance its regulatory policies, procedures and operations. During 2010, there has been specific, targeted focus on enhancing arrangements for handling customer complaints and managing the risks associated with money laundering, and sanctions and terrorism financing.
Reputational risk	The risks arising from the failure to meet stakeholders' perceptions and expectations.	Failure of the business to provide an experience which meets customers, regulators and other stakeholder's expectations.	Government support brings heightened public scrutiny of the way the RBS Group manages its business including: staff remuneration, how customers are managed, the levels of lending in the UK and environmental impact.	In 2010, the RBS Group established the Group Corporate Sustainability Committee, and also developed a framework for managing environmental, social and ethical risks to support its lending decisions. Businesses consider potential reputational risks and appropriate mitigants.
Pension risk	The risk that the Group may have to make additional contributions to its defined benefit pension schemes.	Volatile funding position caused by the uncertainty of future investment returns and the projected value of schemes' liabilities.	The triennial funding valuation for the Main scheme was undertaken in 2010 with a schedule of contributions to be agreed with the Trustees.	During 2010, the RBS Group implemented an enhanced reporting and modelling framework to improve the identification and management of key pension risks. In early 2010 the Main scheme increased its bond allocation to better match liabilities.

Each of these maps into the Groups risk appetite framework and contribute to the overall achievement of the strategic objectives with underlying frameworks and limits. The key frameworks and developments this year are described in the relevant section of the following pages.

* unaudited

Balance sheet management

Capital*

All the disclosures in this section (pages 27 to 32) are unaudited and are marked by an asterisk (*).

It is the 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 Group has regard to the supervisory requirements of the FSA.

Group Treasury in conjunction with the divisions and Risk Management, in respect of risk-weighted assets (RWAs), manage and control the Group's balance sheet risks and consequent impact on the RBS Group's capital, funding, liquidity, interest rate risk and currency risks.

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 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%.

Risk-weighted assets

	Group		
	2010 £bn	2009 £bn	2008 £bn
Credit risk	349.4	350.8	346.8
Counterparty risk	51.1	59.4	68.1
Market risk	78.9	63.2	30.2
Operational risk	35.9	33.7	36.6
	515.3	507.1	481.7
Asset Protection Scheme relief	(105.6)	(116.3)	n/a
	409.7	390.8	481.7

Risk asset ratio

	%	%	%
Core Tier 1	8.4	8.6	5.3
Tier 1	10.1	10.5	8.5
Total	13.6	14.8	14.2

Key points

- During the year the Group increased Core Tier 1 capital by £0.9 billion following a capital injection by RBS Group.
- Credit and counterparty RWAs fell by £9.7 billion principally driven by an improvement in risk parameters and Non-Core disposals partially offset by regulatory and modelling changes.
- Market risk RWAs increased by £15.7 billion during the year principally due to an event risk charge.
- The reduction in APS RWA relief relates to the run-off of covered assets.

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 RBS Group Board and allocated to divisions to manage their allocated RWAs.

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

Individual Capital Adequacy Assessment Process (ICAAP)

In addition to the calculation of minimum capital requirements for credit, market and operational risk, banks are required to undertake an ICAAP for other risks. The RBS Group's ICAAP is conducted on a consolidated basis and, in particular, focuses on pension fund risk, interest rate risk in the banking book together with stress tests to assess the adequacy of capital over one year and the economic cycle. This is cascaded to the relevant entities in the RBS Group, including the Group.

Financial review continued

Balance sheet management: Capital* continued

Capital resources

The Group's regulatory capital resources in accordance with the FSA definitions were as follows:

Composition of regulatory capital	Group		
	2010 £m	2009 £m	2008 £m
Tier 1			
Ordinary shareholders' equity	55,589	53,630	36,711
Non-controlling interests	597	1,146	1,292
Adjustments for:			
- goodwill and other intangible assets - continuing businesses	(11,832)	(11,814)	(12,591)
- goodwill and other intangible assets - discontinued businesses	—	(238)	—
- unrealised losses on available-for-sale (AFS) debt securities	(843)	279	1,855
- reserves arising on revaluation of property and unrealised gains on AFS equities	(74)	(184)	(154)
- other regulatory adjustments	(818)	(796)	(56)
Less excess of expected losses over provisions net of tax	(1,998)	(2,560)	(771)
Less securitisation positions	(1,916)	(1,270)	(561)
Less APS first loss	(4,225)	(4,654)	—
Core Tier 1 capital	34,480	33,539	25,725
Preference shares	2,890	2,883	10,896
Innovative Tier 1 securities	3,638	3,542	4,177
Tax on the excess of expected losses over provisions	797	1,020	307
Less material holdings	(242)	(132)	(85)
Total Tier 1 capital	41,563	40,852	41,020
Tier 2			
Reserves arising on revaluation of property and unrealised gains on AFS equities	74	184	154
Collective impairment provisions	672	796	666
Perpetual subordinated debt	4,925	7,170	12,085
Term subordinated debt	18,067	18,860	16,488
Non-controlling and other interests in Tier 2 capital	11	11	11
Less excess of expected losses over provisions	(2,795)	(3,580)	(1,079)
Less securitisation positions	(1,916)	(1,270)	(561)
Less material holdings	(242)	(132)	(85)
Less APS first loss	(4,225)	(4,654)	—
Total Tier 2 capital	14,571	17,385	27,679
Supervisory deductions			
Unconsolidated investments	(116)	(121)	(119)
Other deductions	(267)	(93)	(111)
Deductions from total capital	(383)	(214)	(230)
Total regulatory capital	55,751	58,023	68,469

* unaudited

Asset Protection Scheme

The RBS Group acceded to the Asset Protection Scheme ('APS' or 'the Scheme') in December 2009.

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 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 RBS Group that extended effective APS protection to all other regulated entities holding assets covered by the APS.

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 write-downs, to date, is deducted from 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, 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 the RBS Group and is risk-weighted in the normal way.

Should the uncapped amount be higher than the capital requirements for the underlying assets calculated as normal, 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 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 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

The RBS Group calculates its capital requirements in accordance with the capped basis. Accordingly, the APS has no impact on the Pillar 1 regulatory capital requirement in respect of the assets covered by the APS. It does, however, improve the Core Tier 1 total capital ratios, of the Group as a whole. The protection afforded by the APS assists the RBS Group in satisfying the forward looking stress testing framework applied by the FSA.

Future regulatory capital effects

As impairments or write-downs on the pool of assets are recognised, they reduce the Core Tier 1 capital in the normal way. This will reduce the first loss deduction for the Scheme, potentially leading to a position where the capital requirement on the uncapped basis would no longer, for the assets covered by the APS, exceed the Non-APS requirement and as a result, the Group would expect to start reporting the regulatory capital treatment on the uncapped basis.

For further information on the APS see page 115.

Balance sheet management: Capital* continued

Regulatory developments

Basel III and CRD IV

The Basel Committee released the final text on the new Basel III Capital and Liquidity Frameworks in December 2010, the contents of which were broadly as expected. Whilst most of the new rules are 'final' there are lengthy observation periods for the more novel elements (the liquidity coverage ratio, the net stable funding ratio and the leverage ratio) designed to identify any unintended consequences prior to full implementation and it is possible that some of the detail may be amended. The capital requirements for credit valuation adjustments (CVAs) with respect to counterparty risk are subject to a final impact assessment which is being carried out in the first quarter of 2011. The Committee's guidance on the countercyclical capital buffers allows for significant judgement which will need to be clarified by national regulators. The potential impacts for RBS Group are set out below.

- national implementation of increased capital requirements will begin on 1 January 2013;
- there will be a phased five year implementation of new deductions and regulatory adjustments to Core Tier 1 capital commencing 1 January 2014;
- the de-recognition of non-qualifying non common Tier 1 and Tier 2 capital instruments will be phased in over 10 years from 1 January 2013; and
- requirements for changes to minimum capital ratios, including conservation and countercyclical buffers, as well as additional requirements for Systemically Important Financial Institutions, will be phased in from 2013 to 2019.

The focus will now be on the EU's implementation of the Basel framework. The Commission's legislative proposal - the Capital Requirements Directive (CRD) IV - is expected to appear in summer 2011.

Contingent capital and loss absorbency

The Basel Committee issued its final rules on the requirements to ensure all classes of capital instruments fully absorb losses at the point of non-viability, before tax payers are exposed to loss. These are designed to combat the experience during the crisis where holders of Tier 2 capital instruments did not suffer any losses when banks were bailed out by the public sector. Debate continues, meanwhile, over possible requirements for bailing-in senior debt holders, as a further means of protecting the taxpayer.

Implementation by the Group

The Group is advanced in its planning to implement these new measures and is appropriately well-capitalised with Core Tier 1 capital of £34 billion and a Core Tier 1 ratio of 8.4% at 31 December 2010.

Basel III capital deductions and regulatory adjustments

In addition to the changes outlined above, Basel III will also result in revisions to regulatory adjustments and capital deductions. These will be phased in over a five year period from 1 January 2014. The initial deduction is expected to be 20%, rising 20 percentage points each year until full deduction by 1 January 2018. However, this is subject to final implementation rules determined by the FSA. The proportion not deducted in the transition years will continue to be subject to existing national treatments.

The major categories of deductions include:

- expected loss net of provisions;
- deferred tax assets not relating to timing differences;
- unrealised losses on available-for-sale securities; and
- significant investments in non-consolidated financial institutions.

The net impact of these adjustments is expected to be manageable as most of these drivers reduce or are eliminated by 2014.

Other regulatory developments

Treatment of Systemically Important Financial Institutions (SIFIs)

Policy development around contingent capital and loss absorbency forms part of a wider policy initiative on addressing systemic institutions. A Financial Stability Board outline framework and plan of action was endorsed by G20 leaders at the November 2010 Seoul Summit. This now forms the main focus of global policy making following the finalisation of the Basel III framework. Policy initiatives in this area may include proposals for greater loss absorbency for systemic firms, the development of enhanced supervision and resolution frameworks, as well as recovery and resolution plans.

* unaudited

The EU Commission Consultation

Crisis management proposals

The EU Commission issued a consultation paper on crisis management measures in January 2011. It covers prevention tools (such as recovery planning requirements, supervisory powers and new ideas on intra-group financial support mechanisms), as well as resolution tools (including partial transfer powers and possible approaches to debt write-down. The consultation will inform draft implementing legislation expected this summer, and is intended to help shape the global framework for SIFIs.

Markets in Financial Instruments Directive Review

The EU Commission published a consultation on revising the Directive on Markets in Financial Instruments (MiFID2). The main proposals in the consultation are the extension of the transparency rules to include bonds and over the counter derivatives, measures to reinforce regulation of commodity derivatives and high frequency trading, strengthening investor protection and detailing the role of the new European Securities and Markets Authority.

Financial activities tax

In a recent speech, the EU Tax Commissioner talked about the introduction of a potential Financial Activities Tax at a European level. There will be an impact assessment in 2011 to review the cumulative impact on financial institutions of new regulation, bank levy and taxes, as part of the Commission's on-going examination of possible tax measures.

Dodd-Frank

In the United States the Dodd-Frank Wall Street Reform and Consumer Reform Act (Dodd-Frank) contains very significant reforms the full effect of which can only be assessed when the implementation rules are finalised. There have also been numerous derivative proposals from the Commodity Futures Exchange Commission (CFTC) and the Securities and Exchange Commission (SEC) plus joint agency proposals to implement minimum capital standards (Collins Amendment) and market risk capital guidelines.

Project Merlin

On 9 February 2011, the UK Government and the major British banks including the Group, announced the creation of an accord, known as Project Merlin, aimed at demonstrating the clear and shared intent to work together to help the UK economy recover and grow. The banks:

- will work to foster credit demand, particularly among small and medium-sized businesses, and will make available additional lending capacity if demand should materialise above their current expectations;
- expect to contribute more in UK tax as their performance strengthens and their profits grow and will jointly contribute an additional £1 billion to the Business Growth Fund;

- confirm that the aggregate 2010 bonus pool including deferrals for their UK-based staff will be lower than that of 2009 and will reflect the engagement each bank has had with the Financial Services Authority, the UK Government and its shareholders, as well as their duty to manage pay policy to protect and enhance the long-term interests of shareholders; and
- will extend disclosure of remuneration details of their most senior executives beyond international norms.

The Government has in the light of the banks' statements affirmed its commitment to maintaining a strong, resilient, stable and globally competitive UK financial services sector, and to implementing and applying European and international regulation to create a level playing field in both policy and practice.

Structure of prudential regulation in the UK

Following the consultation by HM Treasury on 'A new approach to financial regulation' in 2010, the government subsequently published further detailed proposals to give the Bank of England responsibility for prudential regulation, and to create a new Consumer Protection and Markets Authority to protect the interests of bank customers.

Increase in the level of customer protection under Financial Services Compensation Scheme

The European Commission has introduced a uniform compensation level of €100,000 across Member States from 1 January 2011. The sterling equivalent was confirmed by HM Treasury as £85,000.

Independent Commission on Banking

The Independent Commission on Banking has published responses from banks, academics and other interested parties to its initial consultation. In its summary of the evidence received the Commission noted that there was considerable interest, both positive and negative, in the question of splitting retail and investment banks. The Commission plans to publish its interim report in April.

FSA Code on remuneration

In July 2009 the European Commission adopted a proposal to further amend the Capital Requirements Directive (CRD) which included proposals on remuneration policies. This was subsequently voted for and approved (CRD III).

CRD III required the Commission of European Banking Supervisors (CEBS) to issue guidelines on sound remuneration policies which comply with its principles and these were issued on 10 December 2010 (the "Guidelines").

Balance sheet management: Capital* continued **Regulatory developments** continued

The FSA amended its Remuneration Code to take into account the Guidelines and published its policy statement on remuneration on 17 December 2010:

The RBS Group is required to be compliant with the FSA Remuneration Code with effect from 1 January 2011:

- as a “Tier 1” organisation, the Code applies to all employees on a global basis;
- there are specific remuneration and governance requirements in relation to “Code Staff”; and
- following an ongoing review of our remuneration arrangements and discussions with the FSA, 2011 RBS remuneration arrangements are fully compliant with the FSA Remuneration Code.

Bank levy

In his 22 June 2010 budget statement, the Chancellor announced that the UK Government will introduce an annual bank levy. The Finance Bill 2011 contains details of how the levy will be calculated and collected. The levy will be collected through the existing quarterly corporation tax collection mechanism starting with payment dates on or after the date the Finance Bill 2011 receives Royal Assent. Further information is included on page 219.

Stress and scenario testing

Stress testing forms part of the RBS Group’s risk and capital framework and is an integral component of Basel II. As a key risk management tool, stress testing highlights to senior management potential adverse unexpected outcomes related to a mixture of risks and provides an indication of how much capital might be required to absorb losses, should adverse scenarios occur. Stress testing is used at both a divisional and Group level to assess risk concentrations, estimate the impact of stressed earnings, impairments and write-downs on capital. It determines the overall capital adequacy under a variety of adverse scenarios. The principal business benefits of the stress testing framework include: understanding the impact of recessionary scenarios; assessing material risk concentrations; forecasting the impact of market stress and scenarios on the Group’s balance sheet liquidity.

A series of stress events are monitored on a regular basis to assess the potential impact of an extreme yet plausible event on the Group. There are four core elements of scenario stress testing:

- macroeconomic stress testing considers the impact on both earnings and capital for a range of scenarios. They entail multi-year systemic shocks to assess the Group’s ability to meet its capital requirements and liabilities as they fall due in a downturn in the business cycle and/or macroeconomic environment;
- enterprise-wide stress testing considers scenarios that are not macroeconomic in nature but are sufficiently broad to impact across multiple risks or divisions and are likely to affect earnings, capital and funding;
- cross-divisional stress testing includes scenarios which have impacts across divisions relating to sensitivity to a common risk factor(s). This would include, for example, sector based stress testing across corporate portfolios and sensitivity analysis to stress in market factors. These stress tests are discussed with senior divisional management and are reported to senior committees across the Group; and
- divisional and risk specific stress testing is undertaken to support risk identification and management. Examples include the daily product based stress testing using a hybrid of hypothetical and historical scenarios within market risk.

Portfolio analysis, using historic performance and forward looking indicators of change, uses stress testing to facilitate the measurement of potential exposure to events and seeks to quantify the impact of an adverse change in factors which drive the performance and profitability of a portfolio.

*unaudited

Funding and liquidity risk

All disclosures in this section (pages 33 to 41) are audited unless indicated otherwise with an asterisk (*).

Introduction

The Group's balance sheet composition is a function of the broad array of product offerings and diverse markets served by its Core divisions. The structural integrity of the balance sheet is augmented as needed through active management of both asset and liability portfolios. The objective of these activities is to optimise liquidity transformation in normal business environments while ensuring adequate coverage of all cash requirements under extreme stress conditions.

Diversification of the Group's funding base is central to the liquidity management strategy. The Group's businesses have developed large customer franchises. The largest being in the UK, US and Ireland but extend into Europe, Asia and Latin America. Customer deposits provide large pools of stable funding to support the majority of the RBS Group's lending. It is a strategic objective to improve the RBS Group's loan to deposit ratio to 100%, or better by 2013.

The Group also accesses professional markets funding by way of public and private debt issuances on an unsecured and secured basis. These debt issuance programmes are spread across multiple currencies, and maturities to appeal to a broad range of investor types, and preferences around the world. This market based funding supplements the RBS Group's structural liquidity needs and in some cases achieves certain capital objectives.

Stress testing

Simulated liquidity stress testing is periodically performed for each business and applied to the major operating subsidiary balance sheets. A variety of firm-specific and market related scenarios are used at the consolidated level and in individual countries. These scenarios include assumptions about significant changes in key funding sources, credit ratings, contingent uses of funding, and political and economic conditions in certain countries. Stress tests are regularly updated based on changing market conditions.

Contingency planning

The RBS Group has a Contingency Funding Plan (CFP) which is maintained and updated as the balance sheet evolves. The CFP is linked to stress test results and forms the foundation for liquidity risk limits. Limits in the business-as-usual environment are bounded by capacity to satisfy the RBS Group's liquidity needs in the stress environments. The CFP provides a detailed description of the availability, size and timing of all sources of contingent liquidity available to the Group in a stress event. These are ranked in order of economic impact and effectiveness to meet the anticipated stress requirement. The CFP includes documented procedures and signoffs for actions that may require businesses to provide access to customer assets for collateralised borrowing, securitisation or sale. Roles and responsibilities for the effective implementation of the CFP are also documented.

Liquidity reserves

The Group maintains liquidity reserves sufficient to satisfy cash requirements in the event of a severe disruption in its access to either wholesale or retail funding sources. The reserves consist of high quality unencumbered government securities and cash held on deposit at central banks. Government securities vary by type and jurisdiction based on local regulatory considerations. The currency mix of the reserves reflects the underlying balance sheet composition.

Regulatory oversight

The Group operates in multiple jurisdictions and is subject to a number of regulatory regimes.

The Group's lead regulator is the Financial Services Authority (FSA). The FSA implemented a new liquidity regime on 1 June 2010. The new rules provide a standardised approach applied to all UK banks. At the RBS Group, the rules focus on the RBS UK Defined Liquidity Group (a subset comprising the RBS Group's five main UK banks; The Royal Bank of Scotland plc, National Westminster Bank Plc, Ulster Bank Limited, Coutts & Company and Adam & Company) and cover adequacy of liquidity resources, controls, stress testing and the Individual Liquidity Adequacy Assessment (ILAA) process. The ILAA informs the Board and FSA of the assessment and quantification of the RBS Group's liquidity risks and their mitigation, and how much current and future liquidity is required. The ILAA was approved by the Board in November 2010. The FSA is expected to issue 'Individual Liquidity Guidance' to the Group in 2011.

In the US, the RBS Group's operations are required to meet liquidity requirements set out by the US Federal Reserve Bank, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Financial Industry Regulatory Authority.

Regulatory developments*

There have been a number of significant developments in the regulation of liquidity risk.

In December 2010, the BCBS issued the 'International framework for liquidity risk measurement, standards and monitoring' which confirmed the introduction of two liquidity ratios, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The introduction of both of these will be subject to an observation period, which includes review clauses to address and identify any unintended consequences.

After an observation period beginning in 2011, the LCR, including any revisions, will be introduced on 1 January 2015. The NSFR, including any revisions, will move to a minimum standard by 1 January 2018.

Balance sheet management: Funding and liquidity risk *continued*

Funding sources

The table below shows the composition of the Group's primary funding sources, excluding third party repurchase agreements.

	2010		Group 2009		2008	
	£m	%	£m	%	£m	%
Deposits by banks						
- cash collateral	26,639	4.1	28,246	4.2	33,160	4.5
- other deposits	23,361	3.6	43,422	6.4	76,489	10.4
- amounts due to fellow subsidiaries	6,626	1.0	8,888	1.3	6,327	0.9
	56,626	8.7	80,556	11.9	115,976	15.8
Debt securities in issue						
- commercial paper	19,764	3.1	23,216	3.4	44,245	6.0
- certificates of deposits	35,370	5.5	56,585	8.4	65,544	8.9
- medium term notes and other bonds	86,606	13.4	76,738	11.4	53,297	7.3
- covered bonds	4,100	0.6	—	—	—	—
- securitisations	18,822	2.9	15,874	2.4	16,856	2.3
	164,662	25.5	172,413	25.6	179,942	24.5
Subordinated liabilities	32,023	4.9	34,717	5.1	39,951	5.4
Total wholesale funding	253,311	39.1	287,686	42.6	335,869	45.7
Customer deposits						
- cash collateral	9,623	1.5	7,970	1.2	12,416	1.7
- other deposits	376,002	58.0	360,516	53.4	368,329	50.1
- amounts due to holding company and fellow subsidiaries	8,934	1.4	18,791	2.8	18,289	2.5
Total customer deposits	394,559	60.9	387,277	57.4	399,034	54.3
Total funding	647,870	100.0	674,963	100.0	734,903	100.0

Key points

- The Group has continued to reduce reliance on wholesale funding and diversify funding sources. Deposits by banks, excluding balances due to the holding company and fellow subsidiaries were reduced by 30% since 31 December 2009.
- The Group's funding from customer deposits, during 2010 increased by £15 billion, from £361 billion at 31 December 2009 to £376 billion at 31 December 2010.

The tables below show the Group's debt securities in issue and subordinated liabilities by maturity.

	Group			
	Debt securities in issue £m	Subordinated liabilities £m	Total £m	%
2010				
Less than one year	80,233	1,076	81,309	41.3
1-5 years	47,471	7,017	54,488	27.7
More than 5 years	36,958	23,930	60,888	31.0
	164,662	32,023	196,685	100.0
2009				
Less than one year	96,732	1,366	98,098	47.4
1-5 years	52,337	4,228	56,565	27.3
More than 5 years	23,344	29,123	52,467	25.3
	172,413	34,717	207,130	100.0
2008				
Less than one year	122,496	1,859	124,355	56.5
1-5 years	27,181	4,215	31,396	14.3
More than 5 years	30,265	33,877	64,142	29.2
	179,942	39,951	219,893	100.00

Key points

- The funding and liquidity position has improved by extending the average maturity of debt securities in issue.
- The proportion of debt instruments with a remaining maturity of greater than one year has increased in 2010 from 53% at 31 December 2009 to 59% at 31 December 2010.

Credit Guarantee Scheme

The table below shows the residual maturity of the Group's outstanding term funding issued under the UK Government's Credit Guarantee Scheme at 31 December 2010.

Residual maturity	£m	%
Q1 2011	196	0.5
Q2 2011	1,224	2.9
Q4 2011	18,728	45.2
Q1 2012	15,593	37.6
Q2 2012	5,714	13.8
	41,455	100.0

Special Liquidity Scheme*

The Group does not use the Special Liquidity Scheme (SLS) to fund its business activities. The Group's outstanding liabilities under the SLS are used to fund elements of its liquidity portfolio. Balances under the SLS continued to reduce in 2010.

*unaudited

Balance sheet management: Funding and liquidity risk continued

Liquidity portfolio

The table below shows the composition of the Group's liquidity portfolio.

	Group	
	2010 £m	2009 £m
Cash and balances at central banks	46,485	22,586
Treasury bills	14,529	30,010
Central and local government bonds (1)		
- AAA rated governments (2)	37,167	19,931
- AA- to AA+ rated governments	2,404	—
	39,571	19,931
Unencumbered collateral (3)		
- AAA rated	11,145	11,239
- below AAA rated and other high quality assets	13,518	17,730
	24,663	28,969
Total liquidity portfolio	125,248	101,496

Notes:

(1) Includes FSA eligible government bonds of £34.7 billion at 31 December 2010.

(2) Includes AAA rated US government guaranteed agencies.

(3) Includes secured assets which are eligible for discounting at central banks, comprising loans and advances and debt securities.

Assets and liabilities by contractual cashflow maturity

The table below shows 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. The balances in the table below do not agree directly to the consolidated balance sheet, as the table includes all cash flows relating to principal and future coupon payments presented on an undiscounted basis.

2010	Group					
	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	49,837	—	—	1	—	—
Loans and advances to banks	18,751	906	408	352	290	71
Debt securities	6,199	5,898	14,576	10,980	31,186	16,782
Settlement balances	8,500	208	—	—	41	—
Other financial assets	—	8	—	15	7	—
Total maturing assets	83,287	7,020	14,984	11,348	31,524	16,853
Loans and advances to customers	96,116	80,731	111,158	64,094	74,733	61,841
Derivatives held for hedging	457	1,434	2,174	515	132	41
	179,860	89,185	128,316	75,957	106,389	78,735
Liabilities by contractual maturity						
Deposits by banks	26,306	3,298	1,276	385	612	374
Debt securities in issue	82,291	36,368	14,783	12,667	12,190	4,100
Subordinated liabilities	13,230	2,741	8,032	5,770	7,404	10,327
Settlement balances and other liabilities	10,309	32	78	67	204	25
Total maturing liabilities	132,136	42,439	24,169	18,889	20,410	14,826
Customer accounts	371,310	17,859	7,459	3,729	2,117	719
Derivatives held for hedging	240	549	919	428	285	28
	503,686	60,847	32,547	23,046	22,812	15,573
Maturity gap	(48,849)	(35,419)	(9,185)	(7,541)	11,114	2,027
Cumulative maturity gap	(48,849)	(84,268)	(93,453)	(100,994)	(89,880)	(87,853)
Guarantees and commitments - notional amount						
Guarantees (1, 2)	10,393	—	—	—	—	—
Commitments (3)	234,203	—	—	—	—	—
	244,596	—	—	—	—	—

For the notes to this table refer to page 38.

Balance sheet management: Funding and liquidity risk continued

Assets and liabilities by contractual cashflow maturity continued

2009	Group					
	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
	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
	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	—	—	—	—	—
	259,731	—	—	—	—	—

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 £12,479 million (2009 - £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.

2008	Group					
	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	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
	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
	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)

The tables above have been prepared on the following basis:

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

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 Group. 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 instrument is triggered by, or is subject to, specific criteria such as market price hurdles being reached, the asset is included in the time band which contains the latest date on which it can be repaid regardless of early repayment. The liability is included in the time band which contains 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 twenty years - the principal amounts of financial assets and liabilities that are repayable after twenty years or where the counterparty has no right to repayment of the principal - are excluded from the table, as are interest payments after twenty years.

Held-for-trading assets and liabilities - held-for-trading assets and liabilities amounting to £645.6 billion (assets) and £587.2 billion (liabilities) (2009 - £638.3 billion assets, £576.0 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.

Balance sheet management: Interest rate risk

The banking book consists of interest bearing assets, liabilities and derivative instruments used to mitigate risks which are accounted for on an accrual basis, as well as non interest bearing balance sheet items which are not subjected to fair value accounting.

The Group provides financial products to satisfy a variety of customer requirements. Loans and deposits are designed to meet customer objectives with regard to repricing frequency, tenor, index, prepayment, optionality and other features. These characteristics are aggregated to form portfolios of assets and liabilities with varying degrees of sensitivity to changes in market rates. Mismatches in these sensitivities give rise to net interest income (NII) volatility as the level of interest rates rise and fall. For example, a bank with a floating rate loan portfolio and largely fixed rate deposits will see its NII rise as interest rates rise and fall as rates decline. Due to the long-term nature of many banking book portfolios, layered repricing characteristics and maturities, it is likely the NII will vary from period to period even with no change in market rate level. New business volumes originated in any period will alter the interest rate sensitivity of a bank if it differs from portfolios originated in prior periods.

Interest rate risk in the banking book (IRRBB) is assessed using a set of standards to define, measure and report the market risk. It is the RBS Group's policy to minimise interest rate sensitivity in banking book portfolios and where interest rate risk is retained to ensure that appropriate measures and limits are applied. Key conventions in evaluating IRRBB are subjected to approval of divisional ALCOs and GALCO. Limits on IRRBB are proposed by the Group Treasurer for approval by ERF annually.

IRRBB is measured using a version of the same VaR methodology that is used for the Group's trading portfolios. Net interest income exposures are measured in terms of sensitivity over time to movements in interest rates. Additionally, Citizens measures the sensitivity of the market value of equity to changes in forward interest rates.

Divisions with the exception of Citizens and GBM are required to manage banking book exposures through internal transactions with Group Treasury to the greatest extent possible. Residual risks in divisions must be measured and reported as described.

Group Treasury aggregates exposures arising from its own external activities and positions transferred in from divisions. Where appropriate, Group Treasury nets offsetting risk exposures to determine a residual exposure to rate movements. Hedging transactions using cash and derivative instruments are executed to manage within the GALCO approved VaR limits.

Citizens and GBM manage their own IRRBB exposures within approved limits to satisfy their business objectives.

IRRBB VaR for the Group's retail and commercial banking activities at a 99% confidence level was as follows:

	Average £m	Period end £m	Maximum £m	Minimum £m
2010	113.6	192.8	192.8	65.4
2009	175.8	166.8	237.1	133.9
2008	185.7	218.5	268.1	122.9

Structural foreign currency exposures

Structural foreign currency exposures represent net investment in subsidiaries, associates and branches, the functional currencies of which are currencies other than sterling. The Group hedges structural foreign currency exposures only in limited circumstances. The Group's objective is to ensure, where practical, that its consolidated capital ratios are largely protected from the effect of changes in exchange rates.

The Group seeks to limit the sensitivity to its Core Tier 1 ratio to 20 basis points in a 10% rate shock scenario. The Group's structural foreign exchange position is reviewed by GALCO regularly.

The tables below set out the Group's structural foreign currency exposures.

	Net investments in foreign operations £m	Net investment hedges £m	Structural foreign currency exposures £m
2010			
US dollar	16,042	(1,250)	14,792
Euro	5,111	(211)	4,900
Swiss franc	1,122	(1,110)	12
Other non-sterling	988	(920)	68
	23,263	(3,491)	19,772
2009			
US dollar	14,904	(3,208)	11,696
Euro	5,340	(259)	5,081
Swiss franc	937	(908)	29
Other non-sterling	870	(853)	17
	22,051	(5,228)	16,823
2008			
US dollar	16,710	(4,302)	12,408
Euro	4,571	(617)	3,954
Swiss franc	912	(912)	—
Brazilian Real	877	(844)	33
	23,070	(6,675)	16,395

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 £1,040 million (2009 - £840 million; 2008 - £820 million) recognised in equity, while a 5% weakening in foreign currencies would result in a loss of £940 million (2009 - £800 million; 2008 - £780 million) recognised in equity.

Risk management: Credit risk

All the disclosures in this section (pages 42 to 90) are audited unless otherwise indicated by an asterisk (*).

Credit risk is the risk of financial loss owing to the failure of customers or counterparties to meet payment obligations. The quantum and nature of credit risk assumed across 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.

Credit risk organisation

The existence of a strong credit risk management organisation is vital to support the ongoing profitability of the RBS Group. The potential for loss through economic cycles is mitigated through the embedding of a robust credit risk culture within the business units and through a focus on the importance of sustainable lending practices. The role of the credit risk management organisation is to own the credit approval, concentration and risk appetite frameworks and to act as the ultimate authority for the approval of credit. This, together with strong independent oversight and challenge, enables the business to maintain a sound lending environment within risk appetite.

Responsibility for development of RBS Group-wide policies, credit risk frameworks, RBS Group-wide portfolio management and assessment of provision adequacy sits within the functional RBS Group Credit Risk organisation (GCR) under the management of the Group Chief Credit Officer. Execution of these policies and frameworks is the responsibility of the risk management organisations located within the RBS Group's business divisions. These divisional credit risk functions work together with GCR to ensure that the Group Board's expressed risk appetite is met within a clearly defined and managed control environment. Each credit risk function within the division is managed by a Chief Credit Officer who reports jointly to a divisional Chief Risk Officer and to the Group Chief Credit Officer. Divisional activities within credit risk include credit approval, transaction and portfolio analysis, early problem recognition and ongoing credit risk stewardship.

GCR is additionally responsible for verifying compliance by the divisions with all RBS Group credit policies. It is assisted in this by a credit quality assurance function owned by the RBS Group Chief Credit Officer and housed within the divisions.

Credit risk appetite

Credit risk appetite is managed and controlled through a series of frameworks designed to limit concentration by sector, counterparty, country or asset class. These are supported by a suite of RBS Group-wide and divisional policies setting out the risk parameters within which business units may operate. Information on the RBS Group's credit portfolios is reported to the Group Board via the divisional and RBS Group level risk committees detailed in the Governance section on page 22.

Product/asset class

- **Retail:** a formal risk appetite framework establishes RBS Group-level statements and thresholds that are cascaded through all retail franchises in the RBS Group and to granular business lines. These include measures that relate to both aggregate portfolios and to origination asset quality that are monitored frequently to ensure consistency with RBS Group standards and appetite. This appetite setting and monitoring then informs the processes and parameters employed in origination activities that 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 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 customers' 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 and personal unsecured transactions and some residential mortgage applications.
- **Wholesale:** formal policies, specialised tools and expertise, tailored monitoring and reporting and in certain cases specific limits and thresholds are deployed to address certain lines of business across the RBS Group where the nature of credit risk incurred could represent a concentration or a specific/heightened risk in some other form. Such portfolios are subject to formal governance, including periodic review, at either RBS Group or divisional level, depending on materiality.

Sector

Across wholesale portfolios, exposures are assigned to, and reviewed in the context of, a defined set of industry sectors. Through this sector framework, appetite and portfolio strategies are agreed and set at aggregate and more granular levels where exposures have the potential to represent excessive concentration or where trends in both external factors and internal portfolio performance give cause for concern. Formal periodic reviews are undertaken at RBS Group or divisional level depending on materiality; these may 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. Specific reporting on trends in sector risk and on status versus agreed appetite and portfolio strategies is provided to senior management and to the Board.

Single name

Within wholesale portfolios, much of the activity undertaken by the credit risk function is organised around the assessment, approval and management of the credit risk associated with a borrower or group of related borrowers.

A formal single name concentration framework addresses the risk of outsized exposure to a borrower or borrower group. The framework includes specific and elevated approval requirements; additional reporting and monitoring; and the requirement to develop plans to address and reduce excess exposures over an appropriate timeframe.

Credit approval authority is discharged by way of a framework of individual delegated authorities 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. Whilst both parties are accountable for the quality of each decision taken, the credit risk management approver holds ultimate sanctioning authority. The level of authority granted to individuals is dependent on their experience and expertise with only a small number of senior executives holding the highest authority provided under the framework. Daily monitoring of individual counterparty limits is undertaken.

At a minimum, credit relationships are reviewed and re-approved annually. The renewal process addresses: borrower performance, including reconfirmation or adjustment of risk parameter estimates; the adequacy of security; and compliance with terms and conditions. For certain counterparties early warning indicators are also in place to detect deteriorating trends of concern in limit utilisation or account performance.

Single name concentrations

Reducing the risk arising from concentrations to single names remains a key focus of management attention. Notwithstanding continued market illiquidity and the impact of negative credit migration caused by the current economic environment, significant progress was made in 2010 and credit exposures in excess of single name concentration limits fell.

Country

Country risk arises from sovereign events (default or restructuring); economic events (contagion of sovereign default to other parts of the economy, cyclical economic shock); political events (convertibility restrictions and expropriation or nationalisation); and natural disaster or conflict. Such events have the potential to impact elements of the RBS Group's credit portfolio that are directly or indirectly linked to the affected country and can also give rise to market, liquidity, operational and franchise risk related losses.

The framework for the RBS Group's appetite for country risk is set by the Executive Risk Forum (ERF) in the form of limits by country risk grade, with sub-limits on medium-term exposure. Authority is delegated to the Group Country Risk Committee to manage exposures within the framework with escalation where needed, to ERF. Specific limits are set for individual countries based on a risk assessment taking into account the RBS Group's franchise and business mix in that country. Additional limitations (for example, on foreign-currency exposure and product types with higher potential for loss in case of country events) may be established to address specific vulnerabilities in the context of a country's outlook and/or the RBS Group's business strategy in a particular country. A country watch list framework is in place to proactively monitor emerging issues and facilitate the development of mitigation strategies.

Global Restructuring Group

The Global Restructuring Group (GRG) manages problem and potential problem exposures in the RBS Group's wholesale credit portfolios. Its primary function is to actively manage the exposures to minimise loss for the RBS Group and, where feasible, to return the exposure to the RBS Group's mainstream loan book.

Originating business units consult with GRG prior to the transfer to GRG when a potentially negative event or trend emerges which might affect a customer's ability to service its debt or increase the RBS Group's risk exposure to that customer. Such circumstances include deteriorating trading performance, likely breach of covenant, challenging macroeconomic conditions, a missed payment or the expectation of a missed payment to the RBS Group or another creditor.

On transfer of the relationship, GRG devises a bespoke strategy that optimises recoveries from the debt. This strategy may also involve GRG reviewing the business operations and performance of the customer. A number of alternative approaches will typically be considered including:

- *Covenant relief*: the temporary waiver or recalibration of covenants may be granted to mitigate a potential or actual covenant breach. Such relief is usually granted in exchange for fees, increased margin, additional security, or a reduction in maturity profile of the original loan.
- *Amendment of restrictive covenants*: restrictions in loan documents may be amended or waived as part of an overall remedial strategy to allow: additional indebtedness; the granting of collateral; the sale of a business; the granting of junior lien on the collateral; or other fundamental change in capital or operating structure of the enterprise.
- *Variation in margin*: contractual margin may be amended to bolster the customer's day-to-day liquidity, with the aim of helping to sustain the customer's business as a going concern. This would normally be accompanied by the RBS Group receiving an exit payment, payment in kind or deferred fee.
- *Payment holidays and loan rescheduling*: payment holidays or changes to the contracted amortisation profile including extensions in contracted maturity or roll-overs may be granted to improve customer liquidity. Such concessions often depend on the expectation that liquidity will recover when market conditions improve or from capital raising initiatives that access alternative sources of liquidity. Recently, these types of concessions have become more common in commercial real estate transactions in situations when a shortage of market liquidity rules out immediate refinancing and short-term forced collateral sales unattractive.

Risk management: Credit risk *continued*
Global Restructuring Group *continued*

Forgiveness of all or part of the outstanding debt: debt may be forgiven or exchanged for equity where a fundamental shift in the customer's business or economic environment means that other forms of restructuring strategies are unlikely to succeed in isolation and the customer is incapable of servicing current debt obligations. Debt forgiveness is often an element in leveraged finance transactions which are typically structured on the basis of projected cash flows from operational activities rather than underlying tangible asset values. Maintaining the business as a going concern with a sustainable level of debt is the preferred option rather than realising the underlying assets, provided that the underlying business model and strategy are considered viable.

Depending on the case in question, GRG may employ a combination of these options in order to achieve the best outcome. It may also consider alternative approaches, either alone or together with the options listed above.

The following are generally considered as options of last resort:

- *Enforcement of security or otherwise taking control of assets:* where the RBS Group holds underlying collateral or other security interest and is entitled to enforce its rights, it may take ownership or control of the assets. The RBS Group preferred strategy is to consider other possible options prior to exercising these rights.
- *Insolvency:* where there is no suitable restructuring option or the business is no longer regarded as sustainable, insolvency will be considered. Insolvency may be the only option that ensures that the assets of the business are properly and efficiently distributed to relevant creditors.

As discussed above GRG will consider a range of possible restructuring strategies. At the time of execution the ultimate outcome of the strategy adopted is unknown and highly dependent on the cooperation of the borrower and the continued existence of a viable business. The customer's financial position, its anticipated future prospects and the likely effect of the restructuring including any concessions are considered by the GRG relationship manager to establish whether an impairment provision is required, subject to divisional and RBS Group governance.

During 2010, GRG completed corporate loan restructurings totalling £5.8 billion (exposures of more than £5 million) in the Group, of which £2.7 billion were classified as impaired. Of these restructurings £2.4 billion related to commercial real estate and £1.8 billion to manufacturing. The incidence of the main types of arrangements in the Group is analysed below:

	% of loans (by value)
Term extensions	57
Debt forgiveness	23
Debt for equity	22
Interest rate concessions and payment moratoriums	37

*unaudited

The total above exceeds 100% as an individual case can involve more than one type of arrangement.

Transfer of restructured loans to the performing book follows assessment by relationship managers in GRG. All cases are individually assessed; when no further losses are expected the loan is returned to performing status. Restructured loans that carry an impairment provision remain classified as impaired. Of the £3.1 billion of corporate loans that were transferred to the performing book with a concession during 2010, loans amounting to £1.8 billion had a negotiated margin increase as compensation for concessions granted.

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 in 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.

Forbearance*

The Group's retail forbearance activities involve granting various contract revisions not normally available such as reduced repayments, payment moratoriums and the roll up of arrears, principally to retail customers with secured lending that are experiencing temporary financial difficulties.

Loans are identified for forbearance primarily as a result of contact from the customer or payment arrears and it is only granted following an assessment of the customer's ability to pay. For those loans that are classified as impaired, the RBS Group's objective is to minimise the loss on these accounts; for currently performing loans the aim is to enable the customer to continue to service the loan.

Forbearance lending for which an impairment loss provision has been recognised remains classified as non-performing. Where the customer met the loan terms prior to modification and where there is an expectation that the customer will meet the revised terms, these loans are classified as performing loans.

Retail loan forbearance arrangements during 2010 totalled £3.3 billion (residential mortgages £3.1 billion) in the Group, of which £1.0 billion were classified as impaired. The incidence of the main types of retail forbearance in the Group is analysed below.

	% of loans (by value)
Reduced repayments	59
Payment moratoriums	20
Roll up of arrears	19
Interest reductions	6
Term extensions	3

The total exceeds 100% as an individual case can involve more than one type of arrangement.

Of the forbearance arrangements agreed in the performing book during 2010, less than 15% were impaired as at 31 December 2010.

Credit risk mitigation*

The RBS Group employs a number of structures and techniques to mitigate credit risk. Netting of debtor and creditor balances will be undertaken in accordance with relevant regulatory and internal policies; exposure on over-the-counter derivative and secured financing transactions is further mitigated by the exchange of financial collateral and documented on market standard terms. Further mitigation may be undertaken 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; 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 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; 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 remains legally effective and enforceable.

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 may be divided into three categories, as follows.

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: as part of the credit assessment process, each counterparty is assigned an internal credit grade derived from a default probability. There are a number of different credit grading models in use across the RBS Group, each of which considers risk characteristics particular to that 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).

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 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

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 exposure at default (EAD) will typically be higher than the current utilisation. The methodologies used in EAD modelling provide an 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 are 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

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 loss given default (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.

Risk management: Credit risk *continued*

Key credit portfolios*

Commercial real estate

The definition of commercial real estate was revised during 2010 to include commercial investment properties, residential investment properties, commercial development properties and residential development properties (including house builders); 2009 data are presented on a consistent basis.

The commercial real estate lending portfolio totalled £87 billion at 31 December 2010, an 11% decrease over the prior year (2009 - £98 billion). The Non-Core portion of the portfolio totalled £46 billion (53% of the portfolio) in 2010 (2009 - £47 billion, or 48% of the portfolio) and includes exposures in Ulster Bank Group as discussed on page 54.

By division (1)	2010			2009		
	Investment £m	Development £m	Total £m	Investment £m	Development £m	Total £m
Core						
UK Corporate	24,879	5,819	30,698	27,143	7,331	34,474
Ulster Bank	4,284	1,090	5,374	6,131	3,838	9,969
US Retail & Commercial	3,061	653	3,714	2,812	1,084	3,896
Global Banking & Markets	904	577	1,481	1,543	590	2,133
	33,128	8,139	41,267	37,629	12,843	50,472
Non-Core						
UK Corporate	7,591	3,263	10,854	7,390	3,959	11,349
Ulster Bank	3,854	8,760	12,614	2,061	6,271	8,332
US Retail & Commercial	1,202	220	1,422	1,409	431	1,840
Global Banking & Markets	20,502	417	20,919	24,638	873	25,511
	33,149	12,660	45,809	35,498	11,534	47,032
	66,277	20,799	87,076	73,127	24,377	97,504

By geography (1)	2010					2009				
	Investment		Development		Total £m	Investment		Development		Total £m
	Commercial £m	Residential £m	Commercial £m	Residential £m		Commercial £m	Residential £m	Commercial £m	Residential £m	
UK (excluding Northern Ireland)	32,978	7,255	1,520	8,296	50,049	36,731	7,042	1,871	10,155	55,799
Island of Ireland	5,051	1,148	2,785	6,578	15,562	5,378	1,047	3,484	6,305	16,214
Western Europe	10,239	707	25	38	11,009	12,156	815	184	77	13,232
US	5,963	1,343	542	412	8,260	6,513	1,355	881	778	9,527
RoW	1,568	25	138	465	2,196	2,068	22	238	404	2,732
	55,799	10,478	5,010	15,789	87,076	62,846	10,281	6,658	17,719	97,504

By geography (1)	2010					2009				
	Investment		Development		Total £m	Investment		Development		Total £m
	Core £m	Non-Core £m	Core £m	Non-Core £m		Core £m	Non-Core £m	Core £m	Non-Core £m	
UK (excluding Northern Ireland)	26,167	14,066	5,997	3,819	50,049	29,195	14,578	7,478	4,548	55,799
Island of Ireland	3,154	3,044	963	8,401	15,562	4,693	1,732	3,702	6,087	16,214
Western Europe	289	10,657	17	46	11,009	471	12,500	67	194	13,232
US	3,328	3,978	733	221	8,260	3,184	4,684	1,289	370	9,527
RoW	190	1,404	429	173	2,196	86	2,004	307	335	2,732
	33,128	33,149	8,139	12,660	87,076	37,629	35,498	12,843	11,534	97,504

Note:

(1) Excludes Rate Risk Management (RRM) and contingent obligations.

Key points

- The decrease in exposure occurred primarily in the UK and Europe in the development and investment books. The asset mix remains relatively unchanged.
- Commercial real estate will remain challenging for key markets, such as the UK, ROI and US, and new business will be accommodated within a reducing limit framework.
- Liquidity in the market remains low with focus on refinancing and support for the existing client base.
- The Ulster Bank Non-Core increase relative to 2009 reflects the swapping of the residual mortgage portfolio for the Commercial real estate portfolio with Ulster Bank Core in the third quarter of 2010.

*unaudited

By sub-sector (1)	2010						2009					
	UK (excl NI) £m	Island of Ireland £m	Western Europe £m	US £m	RoW £m	Total £m	UK (excl NI) £m	Island of Ireland £m	Western Europe £m	US £m	RoW £m	Total £m
Residential	15,551	7,726	745	1,755	490	26,267	17,197	7,352	892	2,134	425	28,000
Office	8,551	1,402	4,429	1,311	837	16,530	9,381	1,536	5,034	1,614	974	18,539
Retail	4,928	669	672	504	106	6,879	5,760	680	998	492	700	8,630
Industrial	10,413	1,780	3,309	2,171	284	17,957	11,374	2,599	3,592	2,044	402	20,011
Mixed/Other	10,606	3,985	1,854	2,519	479	19,443	12,087	4,047	2,716	3,243	231	22,324
	50,049	15,562	11,009	8,260	2,196	87,076	55,799	16,214	13,232	9,527	2,732	97,504

Maturity profile of portfolio (1)	2010 £m
< 1 year (2)	22,427
1-2 years	17,987
2-3 years	12,775
>3 years	33,887
	87,076

Notes:

(1) Excludes RRM and contingent obligations.

(2) Includes on demand and past due assets.

Key points

- Of the total portfolio, £45.2 billion (2009 - £57.4 billion) is managed normally with annual reviews, £9.2 billion (2009 - £17.9 billion) is receiving heightened credit oversight under the RBS Group watchlist process ("watch") and £32.6 billion (2009 - £22.2 billion) is managed within the GRG.
- As of 31 December 2010, 55% of the Group's credit risk assets rated AQ10 relate to the property sector, up from 51% at 31 December 2009. Consistent with the trend seen in the total portfolio, the rate of migration to default slowed during the second half of 2010 in most portfolios. In Non-Core and Ulster Bank, property remains the primary driver of growth in the defaulted loan book.
- Short-term lending to property developers without firm long-term financing in place is characterised as speculative. Speculative lending at origination represents less than 2% of the portfolio. The RBS Group's appetite for originating speculative commercial real estate lending is very limited and any such business requires senior management approval. Current market conditions have resulted in some borrowers experiencing difficulty in finalising long-term finance arrangements. These borrowers are managed within the problem debt management process in "watch" or GRG.
- Tighter risk appetite criteria for new business origination have been implemented during the year but will take time to be reflected in the performance of the portfolio. Whilst there has been some recovery in the value of prime properties in the UK, the RBS Group observes that it has been selective. To date this improvement has not fed through into lower quality properties in the UK and has not been evident in other regions, notably the eurozone, Republic of Ireland and the US.
- The RBS Group may agree maturity extensions, interest roll-ups and other remedial measures, as part of the RBS Group's early problem management framework for customers experiencing temporary financial difficulties. Excluding Ulster Bank Group, customers with loans totalling £0.6 billion (where exposures exceeded £10 million) benefited from such measures during 2010. Within GRG a restructured loan without an impairment provision is returned to the performing book once the revised terms are being met by the customer. During 2010, within GRG (excluding Ulster Bank Group) such activity for counterparties with exposures in excess of £5 million amounted to £0.3 billion. Refer to page 51 for discussion on Ulster Bank Group.

Financial review continued

Risk management: Credit risk continued Key credit portfolios* continued

Retail assets

The Group's retail lending portfolio includes mortgages, credit cards, unsecured loans, auto finance and overdrafts. The majority of personal lending exposures are in the UK, Ireland and the US. The analysis below includes both Core and Non-Core balances.

Personal credit risk assets (1)	2010 £m	2009 £m	2008 £m
UK Retail			
- mortgages	92,592	85,529	74,528
- cards, loans and overdrafts	18,072	20,316	22,475
Ulster Bank			
- mortgages	21,162	22,304	24,531
- other personal	1,017	1,172	1,350
Citizens			
- mortgages	24,575	26,534	34,394
- auto and cards	6,062	6,917	9,126
- other (2)	3,455	4,205	5,286
	166,935	166,977	171,690

Notes:

- (1) Prior years have been revised to reflect improvements in data categorisation.
(2) Mainly student loans and recreational vehicles/marine.

Refer to the section on Ulster Bank Group on page 53 for discussion on Ulster Bank residential mortgages.

Residential mortgages

The table below details the distribution of residential mortgages by indexed LTV.

Distribution by average LTV (1)	UK Retail			Citizens		
	2010 %	2009 %	2008 %	2010 %	2009 (2) %	2008 %
<= 50%	38.5	39.2	46.1	25.8	26.4	29.7
> 50% and <= 70%	23.2	21.0	21.5	17.3	16.6	19.7
> 70% and <= 90%	26.2	24.5	19.7	27.4	26.3	31.8
> 90%	12.1	15.3	12.7	29.5	30.7	18.8
Total portfolio average LTV at 31 December	58.2	59.1	54.5	75.3	74.5	69.1
Average LTV on new originations during the year	64.2	67.2	67.2	64.8	62.6	64.3

Notes:

- (1) LTV averages are calculated by transaction volume.
(2) Revised to reflect updated data and analysis completed after the reporting date.
(3) Analysis covers the main mortgage brands in each of the Group's three consumer markets and covers 96% of total mortgage portfolio.

The table below details residential mortgages which are three months or more in arrears (by volume).

	2010 %	2009 %	2008 %
UK Retail (1)	1.7	1.6	1.3
Citizens	1.4	1.5	0.9

Note:

- (1) Based on the 3+ months arrears rate for RBS and NatWest (81% of standard mortgages as at December 2010) together with the equivalent manually applied collections status flag for RBS/NatWest 'Offset' and other brand mortgages; in total 93% of total mortgage assets. The 'One Account' current account mortgage is excluded (£6.7 billion of assets - 7% of assets) of which 0.8% of accounts were 90 days continually in excess of the limit at 31 December 2010 (2009 - 0.6%). Consistent with the way the Council of Mortgage Lenders publishes member arrears information the 3+ month's arrears rate now excludes accounts in repossession and cases with shortfalls post property sale; 2009 data have been revised accordingly.

*unaudited

UK residential mortgages

Key points

- The UK mortgage portfolio totalled £92.6 billion at 31 December 2010, an increase of 8% from 31 December 2009, due to continued strong sales growth and lower redemption rates in historical terms. Of the total portfolio, 98% is designated as Core business with the primary brands being the Royal Bank of Scotland, NatWest, the One Account and First Active (Non-Core is made up of Direct Line Mortgages). The assets comprise prime mortgage lending and include 6.8% (£6.2 billion) of exposure to residential buy-to-let. There is a small legacy self certification book (0.3% of total assets); which was withdrawn from sale in 2004.
- Gross new mortgage lending in 2010 was strong at £15.9 billion. The average LTV for new business during 2010 was 64.2% compared with 67.2% in 2009. The maximum LTV available to new customers remains at 90%. Based on the Halifax House Price index as at September 2010, the book averaged indexed LTV has reduced to 58.2% from 59.1% at 31 December 2009 influenced by favourable house price movements with the proportion of balances in negative equity at 31 December 2010 standing at 6.9% down from 10.9% at 31 December 2009.
- The arrears rate (more than 3 payments in arrears, excluding reposessions and shortfalls post property sale) increased slightly to 1.7% at 31 December 2010 from 1.6% at 31 December 2009. After a period of deterioration the arrears rate has stabilised and has remained broadly stable since late 2009. The arrears rate on the buy-to-let portfolio was 1.3% at 31 December 2010 (2009 - 1.4%).
- The mortgage impairment charge was £183 million for the year ended 31 December 2010 compared to £129 million in 2009, with a proportion of the 2010 charge (approximately £70 million) being the result of adjustments reflecting reduced expectations of recovery on prior period defaulted debt and refinement of provision methodology. Underlying default trends improved throughout 2010 when compared with 2009. Provisions as a percentage of loans and receivables have increased to 0.37% at December 2010 compared with 0.25% at 31 December 2009. Default and arrears rates remain sensitive to economic developments and are currently supported by the low interest rate environment and strong book growth with recent business yet to mature.
- A number of initiatives aimed at supporting customers experiencing temporary financial difficulties remain in place. Forbearance activities include offering reduced or deferred payment terms on a temporary basis for a period of up to 12 months during which arrears continue to accrue on the account. Forbearance activities in the performing book amounted to £0.6 billion during 2010. It is Group policy not to initiate repossession proceedings for at least six months after arrears are evident. The number of properties reposessed in 2010 was 1,392 compared to 1,251 in 2009.

Citizens real estate

Key points

- Citizens total residential real estate portfolio totalled \$38.2 billion at 31 December 2010 (2009 - \$42.5 billion). The real estate portfolio comprises \$9.7 billion (Core: \$8.6 billion; Non-Core: \$1.1 billion) of first lien residential mortgages and \$28.5 billion (Core: \$23.7 billion; Non-Core: \$4.8 billion) of home equity loans and lines (first and second lien). Home Equity Core consists of 46% first lien position while Non-Core consists of 97% second lien position. The Core business comprises 84% of the portfolio and Non-Core comprising 16%, with the serviced by others (SBO) portfolio being the largest component (75%) of the Non-Core portfolio.
- Citizens continue to focus primarily on the 'footprint states' of New England, Mid-Atlantic and Mid-West targeting low risk products and maintaining conservative risk policies. Loan acceptance criteria were tightened during 2009 to address deteriorating economic and market conditions. As at 31 December 2010, the portfolio consisted of \$31.5 billion (82% of the total portfolio) in these footprint states.
- The SBO portfolio is part of Non-Core and consists of purchased pools of home equity loans and lines (96% second lien) with current LTV (105%) and geographic profiles (73% outside of Citizens footprint) leading to an annualised charge-off rate of 10.6% in 2010. The SBO book has been closed to new purchases since the third quarter of 2007 and is in run-off, with exposure down from \$5.5 billion at 31 December 2009 to \$4.5 billion at 31 December 2010. The arrears rate of the SBO portfolio decreased from 3.1% at 31 December 2009 to 2.7% at 31 December 2010 due to more effective account servicing and collections, following a service conversion in 2009.
- The current weighted average LTV of the real estate portfolio increased slightly from 74.5% at 31 December 2009 to 75.3% at 31 December 2010, driven by a down turn in home prices. The current weighted average LTV of the real estate portfolio excluding SBO is 70.0%.
- The arrears rate decreased slightly from 1.5% at 31 December 2009 to 1.4% at 31 December 2010. Delinquency rates have stabilised in recent months for both residential mortgages and home equity loans and lines. Citizens' participates in the US Government Home Affordable Modification Program (HAMP) alongside other bank sponsored initiatives. Under HAMP, any borrower requesting a modification must be first reviewed to see if they meet the criteria of this programme. If the borrower does not qualify for HAMP, then they are reviewed for internal modification programmes. The HAMP programme is available only for first lien loans to owner-occupied. All second lien home equity lines and loans are modified using internal programmes.
- The cumulative effect of these arrangements has helped the Group's customers. Modified loan balances were \$566 million at 31 December 2010 (31 December 2009 - \$235 million).

Risk management: Credit risk *continued*
Key credit portfolios* *continued*

Retail credit assets: Personal lending

The Group's personal lending portfolio includes credit cards, unsecured loans, auto finance and overdrafts. The majority of personal lending exposures exist in the UK and the US. New defaults as a proportion of average loans and receivables are shown in the following table.

	2010		2009		2008	
	Average loans and receivables £m	Impairment charge as a % of loans and receivables %	Average loans and receivables £m	Impairment charge as a % of loans and receivables %	Average loans and receivables £m	Impairment charge as a % of loans and receivables %
Personal lending						
UK Retail cards (1)	6,025	5.0	6,101	8.7	6,617	6.4
UK Retail loans (1)	9,863	4.8	12,062	5.9	13,545	3.3
	\$m	%	\$m	%	\$m	%
Citizens cards (2,3)	1,555	9.9	1,772	9.7	2,275	4.9
Citizens auto loans (2)	8,133	0.6	9,759	1.2	11,386	1.1

Notes:

- (1) The ratio for UK Retail assets refers to the impairment charges for the year.
- (2) The ratio for Citizens refers to charge offs in the year, net of recoveries realised in the year.
- (3) The 2009 data have been revised to exclude the Kroger Personal Finance portfolio, which was sold in 2010.

Key points

- The UK personal lending portfolio, of which 98% is in Core businesses, comprises credit cards, unsecured loans and overdrafts and totalled £18 billion at 31 December 2010 (2009 - £20.3 billion), a decrease of 11% due to continued subdued loan recruitment activity and a continuing general market trend of customers repaying unsecured loan balances with cards and current account balances remaining stable. The Non-Core portfolio consists of the direct finance loan portfolios (Direct Line, Lombard, Mint and Churchill), and totalled £0.45 billion at 31 December 2010 (2009 - £0.7 billion).
- Risk appetite continues to be actively managed across all products. Support continues for customers experiencing financial difficulties through "breathing space initiatives" on all unsecured products, whereby a thirty day period is given to allow customers to establish a debt repayment plan. During this time the Group suspends collection activity. A further extension of thirty days can be granted if progress is made and discussions are continuing. Investment in collection and recovery processes continues, addressing both continued support for the Group's customers and the management of impairments.
- Benefiting from a combination of risk appetite tightening and a more favourable economic environment, impairment losses on unsecured lending have reduced significantly during 2010 from £1,603 million at 31 December 2009 to £991 million at 31 December 2010 with the downward trajectory moderating significantly in the latter part of the year. Impairments will remain sensitive to the external environment.
- Industry benchmarks for cards arrears remain stable, with RBS continuing to perform favourably.
- Outstanding balances for the Citizens credit card portfolio totalled US\$1.53 billion, at 31 December 2010. This figure excludes the Kroger Personal Finance portfolio, which was sold on 27 May 2010. Core assets comprised 86.3% of the portfolio.
- The Citizens cards business has traditionally adopted conservative risk strategies compared to the US market as a whole. Given the economic climate, Citizens has over the past 24 months introduced tighter lending criteria and lower credit limits. These actions have led to improving new business quality and a business performing on par with industry benchmarks (provided by VISA). The latest available metrics show the rate for 60+ days delinquency as a percentage of total outstanding balances at 3.17% in December 2010 (compared to an industry figure of 3.22%) and net contractual charge-offs as a percentage of total outstanding balances at 4.76% in December 2010 (compared to an industry figure of 5.67%). We expect further improvement based on early delinquency trends.
- Citizens is a leading regional provider of retail auto financing to US consumers through a network of 3,433 auto dealers located in 23 US states. Citizens maintain a conservative, prime indirect auto lending credit programme with loss rates that have historically been below national averages. Current outstanding retail auto loan balances totalled \$7.9 billion (includes Core and Non-Core) at 31 December 2010 of which 96% of the portfolio is in the Core business. The \$324 million of Non-Core auto assets are anticipated to run-off by 2013. The tightening of credit parameters in 2008-2009, along with enhanced collection activities and seasonal factors, has resulted in improved credit performance. The net charge-off rate on the total auto portfolio fell to 0.34% at 31 December 2010, down from 1.3% at 31 December 2009. The 30+ DPD delinquency rate fell from 2.6% at 31 December 2009 to 1.6% at 31 December 2010 even as balances fell by \$917 million. The 1.7% 30+ DPD delinquency rate on the total auto loan portfolio at 30 September 2010 Citizens was favourable to the 2.6% nationwide bank indirect auto delinquency rate as reported by Experian.

*unaudited

Ulster Bank Group (Core and Non-Core)*

Ulster Bank Group accounts for 10% of the Group's total loans to customers or 9% of the Group's Core loans to customers. The Irish economy has experienced severe economic headwinds resulting in a substantial rise in unemployment and a steep property value correction over the last two years. Ulster Bank Group has not been immune to the downturn which has resulted in a significant migration of credit quality to lower grades and a substantial increase in loan impairments. Ulster Bank Group's commercial real estate and mortgage portfolios have been acutely affected and these account for 81% of the 2010 impairment charges (2009 - 75%).

Core

Impairment charges increased by £512 million at 31 December 2009 to £1,161 million at 31 December 2010, reflecting the deteriorating economic environment in Ireland with rising default levels across both personal and corporate portfolios. Lower asset values, particularly property related, together with pressure on borrowers with a dependence on consumer spending have resulted in higher corporate loan losses while higher unemployment, lower incomes and increased taxation have driven mortgage impairment increases. Ulster Bank Group is helping customers in this difficult environment. Forbearance policies which are deployed through the 'Flex' initiative are aimed at assisting customers in financial difficulty. These policies have been reviewed in 2010 given the

structural problem that exist in Ireland with the scale and duration of customers in financial difficulty. The industry definition in the Republic of Ireland of an unsustainable mortgage (18 months accumulated interest) has been used to underpin the policy which will improve identification of customers where forbearance may not be appropriate. The forbearance portfolios account for 5.8% (7,383 mortgages) of the Ulster Bank Group mortgage portfolio (by value) at 31 December 2010 with 75% of these customers (by value) in amortising or interest only agreements.

Non-Core

Impairment charges increased from £1,277 million at 31 December 2009 to £2,682 million at 31 December 2010, reflecting the deteriorating economic environment in Ireland with rising default levels across the portfolio. Lower asset values, in property related lending and most specifically in development lending have resulted in higher corporate loan losses.

In the third quarter of 2010, £6.1 billion of residential mortgages and some corporate exposures were transferred from Non-Core to Core; at the same time £5 billion of commercial real estate loans were transferred from Core to Non-Core.

Risk elements in lending and impairments by sector

2010	Gross loans (1,2) £m	REIL £m	Provisions £m	REIL as a % of gross loans %	Provisions as a % of REIL %	Provisions as a % of gross loans %	Impairment charge £m	Amounts written-off £m
Ulster Bank Group								
Mortgages	21,162	1,566	439	7.4	28.0	2.1	336	7
Personal unsecured	1,282	185	158	14.4	85.4	12.3	48	30
Commercial real estate								
- investment	8,138	2,989	1,332	36.7	44.6	16.4	889	—
- development	9,850	6,406	2,820	65.0	44.0	28.6	1,875	—
Other corporate	11,009	2,515	1,228	22.8	48.8	11.2	695	11
	51,441	13,661	5,977	26.6	43.8	11.6	3,843	48
Core								
Mortgages	21,162	1,566	439	7.4	28.0	2.1	294	7
Personal unsecured	1,282	185	158	14.4	85.4	12.3	48	30
Commercial real estate								
- investment	4,284	598	332	14.0	55.5	7.7	259	—
- development	1,090	65	37	6.0	56.9	3.4	116	—
Other corporate	9,039	1,205	667	13.3	55.4	7.4	444	11
	36,857	3,619	1,633	9.8	45.1	4.4	1,161	48
Non-Core								
Mortgages	—	—	—	—	—	—	42	—
Commercial real estate								
- investment	3,854	2,391	1,000	62.0	41.8	25.9	630	—
- development	8,760	6,341	2,783	72.4	43.9	31.8	1,759	—
Other corporate	1,970	1,310	561	66.5	42.8	28.5	251	—
	14,584	10,042	4,344	68.9	43.3	29.8	2,682	—

Financial review continued

Risk management: Credit risk continued Ulster Bank Group (Core and Non-Core)* continued Risk elements in lending and impairments by sector continued

2009	Gross loans (1) £m	REIL £m	Provisions £m	REIL as a % of gross loans %	Provisions as a % of REIL %	Provisions as a % of gross loans %	Impairment charge £m	Amounts written-off £m
Ulster Bank Group								
Mortgages	22,201	882	153	4.0	17.3	0.7	116	3
Personal unsecured	2,433	174	145	7.2	83.3	6.0	66	27
Commercial real estate								
- investment	8,192	1,748	413	21.3	23.6	5.0	370	—
- development	10,109	4,268	1,106	42.2	25.9	10.9	953	4
Other corporate	12,479	1,976	648	15.8	32.8	5.2	421	—
	55,414	9,048	2,465	16.3	27.2	4.4	1,926	34
Core								
Mortgages	16,199	558	102	3.4	18.3	0.6	74	3
Personal unsecured	2,433	174	145	7.2	83.3	6.0	66	27
Commercial real estate								
- investment	6,131	250	105	4.1	42.0	1.7	84	—
- development	3,838	428	284	11.2	66.4	7.4	221	4
Other corporate	11,106	850	326	7.7	38.4	2.9	204	—
	39,707	2,260	962	5.7	42.6	2.4	649	34
Non-Core								
Mortgages	6,002	324	51	5.4	15.7	0.8	42	—
Commercial real estate								
- investment	2,061	1,498	308	72.7	20.6	14.9	286	—
- development	6,271	3,840	822	61.2	21.4	13.1	732	—
Other corporate	1,373	1,126	322	82.0	28.6	23.5	217	—
	15,707	6,788	1,503	43.2	22.1	9.6	1,277	—

Notes:

- (1) Funded loans.
 (2) Ulster Bank Group additionally had £3 billion of lending to financial institutions at 31 December 2010.

Key points

- Increases in REIL reflect difficult conditions in both commercial and residential sectors in the Republic of Ireland. Of the REIL at 31 December 2010, 74% was in Non-Core.
- Provisions increased from £2.5 billion to £6.0 billion and the coverage ratio increased to 44% from 27% at 31 December 2009. 69% of the provision at 31 December 2010 related to commercial real estate.

*unaudited

Residential mortgages

The table below shows how the steep value correction has affected the distribution of residential mortgages by loan-to-value (LTV) (indexed). LTV is based upon gross loan amounts and, whilst including defaulted loans, does not account for impairments already taken.

By average LTV (1)	2010 %	2009 %	2008 %
<= 50%	35.9	40.7	47.1
> 50% and <= 70%	13.5	15.2	17.1
> 70% and <= 90%	13.5	15.5	18.2
> 90%	37.1	28.6	17.6
Total portfolio average LTV at 31 December	71.2	62.5	54.3
Average LTV on new originations during the year	75.9	72.8	71.1

Note:

(1) LTV averages calculated by transaction volume.

Key points

- The residential mortgage portfolio across Ulster Bank Group totalled £21.2 billion at 31 December 2010; with 90% in the Republic of Ireland and 10% in Northern Ireland. The portfolio size has declined by 4% in the Republic of Ireland since 31 December 2009 with Northern Ireland increasing by 12% over the same period. New business originations continue to be very low, especially in the Republic of Ireland. In 2010, 3,557 new mortgages were originated of which, 92% were in Northern Ireland.
- The arrears rate continues to increase due to the continued challenging economic environment. At 31 December 2010, the arrears rate was 6.0%, compared to 3.3% at 31 December 2009. As a result, the impairment charge for 2010 was £336 million compared with £116 million for 2009. Repossessions totalled 76 in 2010, compared with 96 in 2009; 75% of the repossessions were voluntary.
- Ulster Bank Group has a number of initiatives in place aimed at increasing the level of support to customers experiencing temporary financial difficulties. At 31 December 2010, forbearance arrangements had been agreed in respect of 5.8% (£1.2 billion) of Ulster Bank Group's residential mortgage portfolio. The majority (79%) relates to customers in the performing book. Loans in respect of which forbearance arrangements were agreed during 2010 amounted to £1.7 billion in the performing book and £0.5 billion in the impaired book.

Risk management: Credit risk continued Ulster Bank Group (Core and Non-Core)* continued

Commercial real estate

The Commercial real estate lending portfolio for Ulster Bank Group totalled £18 billion at 31 December 2010 and decreased by 2% during the year. The Non-Core portion of the portfolio totalled £12.6 billion (70% of the portfolio). Of the total Ulster Bank Group commercial real estate portfolio, 24% is in Northern Ireland, 63% is in the Republic of Ireland and 13% is in the UK.

The definition of commercial real estate was revised during 2010 to include commercial investment properties, residential investment properties, commercial development properties and residential development properties which include house builders.

Exposure by geography

	Development		Investment		Total £m
	Commercial £m	Residential £m	Commercial £m	Residential £m	
2010					
Island of Ireland	2,785	6,578	5,072	1,098	15,533
UK (excluding Northern Ireland)	110	359	1,831	115	2,415
Other	—	17	22	1	40
	2,895	6,954	6,925	1,214	17,988
2009					
Island of Ireland	3,404	6,305	5,453	1,047	16,209
UK (excluding Northern Ireland)	240	153	1,586	83	2,062
Other	—	7	1	22	30
	3,644	6,465	7,040	1,152	18,301

Property remains the primary driver of growth in the defaulted loan book for Ulster Bank Group. The outlook remains challenging with limited liquidity in the marketplace to support refinancing. The decrease in asset valuations has placed pressure on the portfolio with more clients seeking renegotiation of terms in the context of granting structural enhancements.

Within its early problem management framework, Ulster Bank Group may agree various remedial measures with customers in the performing book that are experiencing temporary financial difficulties. During 2010, customers with loans amounting to £0.4 billion (exposures greater than £5 million) benefited from such measures. During 2010, impaired loans amounting to £2.1 billion (exposures greater than £5 million) were restructured and remain in the non-performing book.

*unaudited

Balance sheet analysis

The following tables provide an analysis of financial assets by industry sector, geography and internal credit quality gradings. Credit risk assets analysed on the preceding pages are reported internally to senior management, however they exclude certain exposures, primarily debt securities, and take account of legal agreements, including master netting arrangements that provide a right of legal set-off but do not meet the criteria for offset in IFRS. The analysis below is therefore provided to supplement the credit risk assets analysis and to reconcile to the consolidated balance sheet.

Industry and geographical analysis

The tables on pages 55 to 68 analyse total financial assets gross of provisions by industry sector and geography.

Industry analysis

The tables below analyses total financial assets by industry.

2010	Group							Netting and offset (2) £m	
	Loans and advances			Securities £m	Derivatives £m	Other (1) £m	Total £m		
	Core £m	Non-Core £m	Total £m						
Total									
Central and local government	7,099	667	7,766	105,502	7,228	285	120,781	3,916	
Finance - banks	82,552	141	82,693	—	—	—	82,693	—	
- other (3)	87,345	7,361	94,706	53,460	385,873	8,066	542,105	396,404	
Residential mortgages	140,351	5,326	145,677	74	6	—	145,757	14	
Personal lending	32,552	3,452	36,004	1	15	7	36,027	11	
Property	41,934	47,081	89,015	2,810	3,730	28	95,583	1,041	
Construction	8,163	3,092	11,255	48	740	—	12,043	1,392	
Manufacturing	19,660	5,469	25,129	719	2,880	—	28,728	2,156	
Service industries and business activities	84,776	17,207	101,983	5,566	11,010	392	118,951	6,532	
Agriculture, forestry and fishing	3,618	133	3,751	29	40	—	3,820	94	
Finance leases and instalment credit	8,273	8,530	16,803	12	14	—	16,829	—	
Interest accruals	800	220	1,020	742	—	—	1,762	—	
Total third-party	517,123	98,679	615,802	168,963	411,536	8,778	1,205,079	411,560	
Amounts due from holding company and fellow subsidiaries	6,624	170	6,794	11	17,469	—	24,274	—	
Total gross of provisions	523,747	98,849	622,596	168,974	429,005	8,778	1,229,353	411,560	
Provisions			(16,770)	(605)	—	—	(17,375)	n/a	
			605,826	168,369	429,005	8,778	1,211,978	411,560	
Comprising:									
Repurchase agreements								10,712	
Derivative balances								357,281	
Derivative collateral								28,245	
Other								15,322	
								411,560	

Risk management: Credit risk *continued*

Balance sheet analysis: Industry and geography analysis *continued*

2009	Group							Netting and offset (2) £m
	Loans and advances			Securities £m	Derivatives £m	Other (1) £m	Total £m	
	Core £m	Non-Core £m	Total £m					
Total								
Central and local government	5,868	808	6,676	110,601	6,924	172	124,373	1,723
Finance - banks	62,279	862	63,141	—	—	—	63,141	—
- other (3)	69,554	9,405	78,959	64,494	388,786	8,946	541,185	365,912
Residential mortgages	127,867	12,332	140,199	64	11	—	140,274	7
Personal lending	34,172	5,168	39,340	1	38	7	39,386	21
Property	48,505	49,626	98,131	4,085	4,136	1	106,353	1,114
Construction	9,039	4,909	13,948	227	908	45	15,128	1,450
Manufacturing	22,356	8,661	31,017	567	2,900	14	34,498	3,120
Service industries and business activities	88,344	24,091	112,435	6,391	10,570	1	129,397	5,833
Agriculture, forestry and fishing	3,545	486	4,031	2	44	—	4,077	76
Finance leases and instalment credit	8,140	11,946	20,086	285	16	—	20,387	—
Interest accruals	1,145	299	1,444	771	—	—	2,215	—
Total third-party	480,814	128,593	609,407	187,488	414,333	9,186	1,220,414	379,256
Amounts due from holding company and fellow subsidiaries	7,145	78	7,223	873	32,020	—	40,116	—
Total gross of provisions	487,959	128,671	616,630	188,361	446,353	9,186	1,260,530	379,256
Provisions			(12,020)	(775)	—	—	(12,795)	n/a
			604,610	187,586	446,353	9,186	1,247,735	379,256

2008	Group					Netting and offset (2) £m		
	Loans and advances £m	Securities £m	Derivatives £m	Other (1) £m	Total £m			
Total								
Central and local government	7,661	66,225	4,319	181	78,386	1,636		
Finance - banks	71,692	—	—	—	71,692	—		
- other (3)	100,141	103,694	840,036	9,034	1,052,905	781,701		
Residential mortgages	138,747	—	14	—	138,761	52		
Personal lending	45,949	248	55	—	46,252	5		
Property	100,676	2,072	5,522	2	108,272	1,026		
Construction	19,032	96	925	6	20,059	1,485		
Manufacturing	46,415	521	7,863	184	54,983	4,029		
Service industries and business activities	133,376	6,498	22,226	1,494	163,594	10,056		
Agriculture, forestry and fishing	4,258	1	48	2	4,309	87		
Finance leases and instalment credit	22,246	3	25	—	22,274	—		
Interest accruals	3,571	1,241	—	—	4,812	—		
Total third-party	693,764	180,599	881,033	10,903	1,766,299	800,077		
Amounts due from holding company and fellow subsidiaries	11,781	—	56,424	—	68,205	—		
Total gross of provisions	705,545	180,599	937,457	10,903	1,834,504	800,077		
Provisions			(6,655)	(142)	—	—	n/a	
			698,890	180,457	937,457	10,903	1,827,707	800,077

For notes to this table refer to page 62.

Loans and advances to banks and customers by geography

The table below analyses loans and advances gross of provisions by geography (location of office).

	Group		
	2010 £m	2009 £m	2008 £m
Loans and advances to banks (1)			
- UK	62,015	44,729	57,368
- US	9,770	8,501	5,337
- Europe	4,469	3,265	3,230
- RoW	6,491	6,762	6,238
Total third-party	82,745	63,257	72,173
Amounts due from fellow subsidiaries	4,848	5,274	7,297
	87,593	68,531	79,470
Loans and advances to customers			
- UK	364,373	366,219	400,983
- US	89,313	89,689	115,923
- Europe	64,649	74,306	88,045
- RoW	14,722	15,936	16,640
Total third-party	533,057	546,150	621,591
Amounts due from holding company and fellow subsidiaries	1,946	1,949	4,484
	535,003	548,099	626,075
	622,596	616,630	705,545

Note:

(1) Loans and advances to banks includes £52 million of accrued interest (2009 - £116 million; 2008 - £481 million).

The tables on pages 57 to 68 analyse financial assets by geography (location of office) and industry for the Group.

2010	Group							Netting and offset (2) £m
	Loans and advances			Securities £m	Derivatives £m	Other (1) £m	Total £m	
	Core £m	Non-Core £m	Total £m					
UK								
Central and local government	6,338	154	6,492	69,587	6,982	173	83,234	3,916
Finance - banks	61,955	14	61,969	—	—	—	61,969	—
- other (3)	54,935	5,966	60,901	26,365	238,329	1,938	327,533	250,121
Residential mortgages	99,927	1,665	101,592	14	6	—	101,612	14
Personal lending	22,101	428	22,529	1	9	—	22,539	11
Property	34,970	30,492	65,462	2,396	3,639	28	71,525	1,041
Construction	7,026	2,296	9,322	39	724	—	10,085	1,392
Manufacturing	12,318	1,538	13,856	277	2,087	—	16,220	2,150
Service industries and business activities	57,161	10,189	67,350	2,139	7,282	339	77,110	6,440
Agriculture, forestry and fishing	2,872	67	2,939	—	35	—	2,974	94
Finance leases and instalment credit	5,589	7,785	13,374	12	14	—	13,400	—
Interest accruals	502	100	602	479	—	—	1,081	—
Total third-party	365,694	60,694	426,388	101,309	259,107	2,478	789,282	265,179
Amounts due from holding company and fellow subsidiaries	4,903	151	5,054	11	14,212	—	19,277	—
	370,597	60,845	431,442	101,320	273,319	2,478	808,559	265,179

Risk management: Credit risk *continued*
Balance sheet analysis: Industry and geography analysis *continued*

2010	Loans and advances			Group			Total £m	Netting and offset (2) £m
	Core £m	Non-Core £m	Total £m	Securities £m	Derivatives £m	Other (1) £m		
US								
Central and local government	169	6	175	25,712	5	112	26,004	—
Finance - banks	9,757	12	9,769	—	—	—	9,769	—
- other (3)	25,156	692	25,848	23,901	121,717	4,574	176,040	123,862
Residential mortgages	20,548	3,653	24,201	60	—	—	24,261	—
Personal lending	6,816	2,704	9,520	—	—	—	9,520	—
Property	1,595	3,318	4,913	99	23	—	5,035	—
Construction	441	79	520	5	16	—	541	—
Manufacturing	4,936	143	5,079	434	583	—	6,096	—
Service industries and business activities	13,858	2,599	16,457	3,267	2,736	43	22,503	—
Agriculture, forestry and fishing	31	—	31	28	3	—	62	—
Finance leases and instalment credit	2,315	—	2,315	—	—	—	2,315	—
Interest accruals	185	70	255	240	—	—	495	—
Total third-party	85,807	13,276	99,083	53,746	125,083	4,729	282,641	123,862
Amounts due from holding company and fellow subsidiaries	797	5	802	—	1,506	—	2,308	—
	86,604	13,281	99,885	53,746	126,589	4,729	284,949	123,862
Europe								
Central and local government	211	507	718	676	64	—	1,458	—
Finance - banks	4,423	45	4,468	—	—	—	4,468	—
- other (3)	737	413	1,150	402	399	24	1,975	1
Residential mortgages	19,467	8	19,475	—	—	—	19,475	—
Personal lending	2,183	320	2,503	—	—	7	2,510	—
Property	4,829	12,087	16,916	—	—	—	16,916	—
Construction	617	677	1,294	—	—	—	1,294	—
Manufacturing	2,211	3,552	5,763	8	—	—	5,771	6
Service industries and business activities	11,701	3,103	14,804	84	—	1	14,889	92
Agriculture, forestry and fishing	712	66	778	1	—	—	779	—
Finance leases and instalment credit	369	745	1,114	—	—	—	1,114	—
Interest accruals	86	49	135	—	—	—	135	—
Total third-party	47,546	21,572	69,118	1,171	463	32	70,784	99
Amounts due from holding company and fellow subsidiaries	332	14	346	—	8	—	354	—
	47,878	21,586	69,464	1,171	471	32	71,138	99

For notes to this table refer to page 62.

2010	Loans and advances			Group			Total £m	Netting and offset (2) £m
	Core £m	Non-Core £m	Total £m	Securities £m	Derivatives £m	Other (1) £m		
RoW								
Central and local government	381	—	381	9,527	177	—	10,085	—
Finance - banks	6,417	70	6,487	—	—	—	6,487	—
- other (3)	6,517	290	6,807	2,792	25,428	1,530	36,557	22,420
Residential mortgages	409	—	409	—	—	—	409	—
Personal lending	1,452	—	1,452	—	6	—	1,458	—
Property	540	1,184	1,724	315	68	—	2,107	—
Construction	79	40	119	4	—	—	123	—
Manufacturing	195	236	431	—	210	—	641	—
Service industries and business activities	2,056	1,316	3,372	76	992	9	4,449	—
Agriculture, forestry and fishing	3	—	3	—	2	—	5	—
Interest accruals	27	1	28	23	—	—	51	—
Total third-party	18,076	3,137	21,213	12,737	26,883	1,539	62,372	22,420
Amounts due from holding company and fellow subsidiaries	592	—	592	—	1,743	—	2,335	—
	18,668	3,137	21,805	12,737	28,626	1,539	64,707	22,420
2009								
UK								
Central and local government	4,478	204	4,682	77,944	6,714	4	89,344	1,723
Finance - banks	43,959	659	44,618	—	—	—	44,618	—
- other (3)	43,371	6,632	50,003	34,331	239,965	3,012	327,311	232,517
Residential mortgages	90,687	1,896	92,583	—	11	—	92,594	7
Personal lending	23,496	951	24,447	1	9	—	24,457	21
Property	36,383	35,401	71,784	3,350	4,056	1	79,191	1,114
Construction	6,964	3,605	10,569	155	849	45	11,618	1,450
Manufacturing	13,699	3,076	16,775	345	2,265	—	19,385	3,120
Service industries and business activities	61,033	14,166	75,199	2,898	7,719	—	85,816	5,833
Agriculture, forestry and fishing	2,946	138	3,084	—	39	—	3,123	76
Finance leases and instalment credit	5,343	10,843	16,186	285	16	—	16,487	—
Interest accruals	865	153	1,018	430	—	—	1,448	—
Total third-party	333,224	77,724	410,948	119,739	261,643	3,062	795,392	245,861
Amounts due from holding company and fellow subsidiaries	5,096	27	5,123	873	26,238	—	32,234	—
	338,320	77,751	416,071	120,612	287,881	3,062	827,626	245,861
US								
Central and local government	172	6	178	24,603	9	141	24,931	—
Finance - banks	8,424	76	8,500	—	—	—	8,500	—
- other (3)	19,034	1,666	20,700	27,155	125,606	5,451	178,912	113,670
Residential mortgages	21,842	4,317	26,159	64	—	—	26,223	—
Personal lending	7,373	3,599	10,972	—	—	—	10,972	—
Property	1,436	3,788	5,224	58	30	—	5,312	—
Construction	490	132	622	72	50	—	744	—
Manufacturing	5,369	336	5,705	221	580	—	6,506	—
Service industries and business activities	13,254	4,140	17,394	3,318	2,457	—	23,169	—
Agriculture, forestry and fishing	27	—	27	1	2	—	30	—
Finance leases and instalment credit	2,417	—	2,417	—	—	—	2,417	—
Interest accruals	202	90	292	334	—	—	626	—
Total third-party	80,040	18,150	98,190	55,826	128,734	5,592	288,342	113,670
Amounts due from holding company and fellow subsidiaries	703	—	703	—	2,812	—	3,515	—
	80,743	18,150	98,893	55,826	131,546	5,592	291,857	113,670

For notes to this table refer to page 62.

Financial review continued

Risk management: Credit risk continued

Balance sheet analysis: Industry and geography analysis continued

2009	Group						Total £m	Netting and offset (2) £m
	Loans and advances			Securities £m	Derivatives £m	Other (1) £m		
	Core £m	Non-Core £m	Total £m					
Europe								
Central and local government	129	598	727	666	33	24	1,450	—
Finance - banks	3,206	57	3,263	—	—	—	3,263	—
- other (3)	810	701	1,511	836	475	29	2,851	—
Residential mortgages	14,948	6,119	21,067	—	—	—	21,067	—
Personal lending	1,865	618	2,483	—	—	7	2,490	—
Property	10,485	8,683	19,168	—	—	—	19,168	—
Construction	1,572	958	2,530	—	—	—	2,530	—
Manufacturing	3,023	4,869	7,892	1	—	—	7,893	—
Service industries and business activities	12,322	4,134	16,456	37	—	—	16,493	—
Agriculture, forestry and fishing	569	348	917	1	—	—	918	—
Finance leases and instalment credit	380	1,084	1,464	—	—	—	1,464	—
Interest accruals	54	39	93	—	—	—	93	—
Total third-party	49,363	28,208	77,571	1,541	508	60	79,680	—
Amounts due from holding company and fellow subsidiaries	434	51	485	—	7	—	492	—
	49,797	28,259	78,056	1,541	515	60	80,172	—
RoW								
Central and local government	1,089	—	1,089	7,388	168	3	8,648	—
Finance - banks	6,690	70	6,760	—	—	—	6,760	—
- other (3)	6,339	406	6,745	2,172	22,740	454	32,111	19,725
Residential mortgages	390	—	390	—	—	—	390	—
Personal lending	1,438	—	1,438	—	29	—	1,467	—
Property	201	1,754	1,955	677	50	—	2,682	—
Construction	13	214	227	—	9	—	236	—
Manufacturing	265	380	645	—	55	14	714	—
Service industries and business activities	1,735	1,651	3,386	138	394	1	3,919	—
Agriculture, forestry and fishing	3	—	3	—	3	—	6	—
Finance leases and instalment credit	—	19	19	—	—	—	19	—
Interest accruals	24	17	41	7	—	—	48	—
Total third-party	18,187	4,511	22,698	10,382	23,448	472	57,000	19,725
Amounts due from holding company and fellow subsidiaries	912	—	912	—	2,963	—	3,875	—
	19,099	4,511	23,610	10,382	26,411	472	60,875	19,725

For notes to this table refer to page 62.

2008	Group					Netting and offset (2) £m
	Loans and advances £m	Securities £m	Derivatives £m	Other (1) £m	Total £m	
UK						
Central and local government	6,033	34,942	3,998	1	44,974	1,636
Finance - banks	56,937	—	—	—	56,937	—
- other (3)	72,536	64,174	449,770	3,454	589,934	426,522
Residential mortgages	80,941	—	14	—	80,955	52
Personal lending	26,182	248	36	—	26,466	5
Property	73,632	1,662	5,073	2	80,369	1,026
Construction	13,346	33	744	—	14,123	1,485
Manufacturing	23,640	263	5,929	56	29,888	3,812
Service industries and business activities	81,968	4,980	13,227	586	100,761	7,710
Agriculture, forestry and fishing	3,118	—	34	1	3,153	87
Finance leases and instalment credit	17,363	3	25	—	17,391	—
Interest accruals	2,655	774	—	—	3,429	—
Total third-party	458,351	107,079	478,850	4,100	1,048,380	442,335
Amounts due from holding company and fellow subsidiaries	11,551	—	44,899	—	56,450	—
	469,902	107,079	523,749	4,100	1,104,830	442,335
US						
Central and local government	352	24,784	45	33	25,214	—
Finance - banks	5,336	—	—	—	5,336	—
- other (3)	20,165	36,408	355,214	5,445	417,232	323,910
Residential mortgages	34,235	—	—	—	34,235	—
Personal lending	14,368	—	—	—	14,368	—
Property	6,475	7	97	—	6,579	—
Construction	885	63	122	6	1,076	—
Manufacturing	10,569	102	1,809	128	12,608	217
Service industries and business activities	25,291	1,133	8,535	907	35,866	2,346
Agriculture, forestry and fishing	30	—	3	1	34	—
Finance leases and instalment credit	3,066	—	—	—	3,066	—
Interest accruals	488	466	—	—	954	—
Total third-party	121,260	62,963	365,825	6,520	556,568	326,473
Amounts due from holding company and fellow subsidiaries	16	—	9,330	—	9,346	—
	121,276	62,963	375,155	6,520	565,914	326,473
Europe						
Central and local government	742	1,335	8	5	2,090	—
Finance - banks	3,206	—	—	—	3,206	—
- other (3)	2,749	455	204	110	3,518	7
Residential mortgages	23,132	—	—	—	23,132	—
Personal lending	3,933	—	19	—	3,952	—
Property	18,618	1	299	—	18,918	—
Construction	4,380	—	57	—	4,437	—
Manufacturing	11,174	1	31	—	11,206	—
Service industries and business activities	20,116	48	136	1	20,301	—
Agriculture, forestry and fishing	1,095	1	1	—	1,097	—
Finance leases and instalment credit	1,793	—	—	—	1,793	—
Interest accruals	337	1	—	—	338	—
Total third-party	91,275	1,842	755	116	93,988	7
Amounts due from holding company and fellow subsidiaries	190	—	8	—	198	—
	91,465	1,842	763	116	94,186	7

For notes to this table refer to page 62.

Risk management: Credit risk *continued*

Balance sheet analysis: Industry and geography analysis *continued*

2008	Group				Total £m	Netting and offset (2) £m
	Loans and advances £m	Securities £m	Derivatives £m	Other (1) £m		
RoW						
Central and local government	534	5,164	268	142	6,108	—
Finance - banks	6,213	—	—	—	6,213	—
- other (3)	4,691	2,657	34,848	25	42,221	31,262
Residential mortgages	439	—	—	—	439	—
Personal lending	1,466	—	—	—	1,466	—
Property	1,951	402	53	—	2,406	—
Construction	421	—	2	—	423	—
Manufacturing	1,032	155	94	—	1,281	—
Service industries and business activities	6,001	337	328	—	6,666	—
Agriculture, forestry and fishing	15	—	10	—	25	—
Finance leases and instalment credit	24	—	—	—	24	—
Interest accruals	91	—	—	—	91	—
Total third-party	22,878	8,715	35,603	167	67,363	31,262
Amounts due from holding company and fellow subsidiaries	24	—	2,187	—	2,211	—
	22,902	8,715	37,790	167	69,574	31,262

Notes:

(1) Includes settlement balances of £8,748 million at 31 December 2010 (2009 - £9,153 million; 2008 - £10,871 million).

(2) This 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 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.

(3) Loans made by the Group's consolidated conduits to assets owing components within Finance.

Industry analysis

2010	Bank							
	Loans and advances			Securities £m	Derivatives £m	Settlement balances £m	Total £m	Netting and offset (1) £m
	Core £m	Non-Core £m	Total £m					
Total								
Central and local government	4,517	647	5,164	78,575	7,223	173	91,135	2,684
Finance - banks	60,783	92	60,875	—	—	—	60,875	—
- other	50,970	3,551	54,521	31,110	384,949	2,947	473,527	387,416
Residential mortgages	42,430	1,665	44,095	14	2	—	44,111	13
Personal lending	5,260	419	5,679	—	7	—	5,686	10
Property	18,242	24,089	42,331	3,310	3,233	28	48,902	427
Construction	3,898	1,512	5,410	39	716	—	6,165	433
Manufacturing	9,015	4,917	13,932	302	2,749	—	16,983	554
Service industries and business activities	40,802	13,545	54,347	2,133	9,804	381	66,665	1,084
Agriculture, forestry and fishing	696	27	723	—	30	—	753	36
Finance leases and instalment credit	262	105	367	10	14	—	391	—
Interest accruals	271	66	337	516	—	—	853	—
Total third-party	237,146	50,635	287,781	116,009	408,727	3,529	816,046	392,657
Amounts due from holding company and subsidiaries	160,957	6,987	167,944	74,726	24,085	—	266,755	—
Total gross of provisions	398,103	57,622	455,725	190,735	432,812	3,529	1,082,801	392,657
Provisions			(5,581)	(511)	—	—	(6,092)	n/a
			450,144	190,224	432,812	3,529	1,076,709	392,657

Comprising:

Repurchase agreements	3,293
Derivative balances	357,192
Derivative collateral	28,245
Other	3,927
	392,657

2009

Total								
Central and local government	3,416	767	4,183	84,588	6,922	8	95,701	465
Finance - banks	43,021	707	43,729	—	—	—	43,729	—
- other	39,111	4,754	43,865	40,175	387,902	4,105	476,047	364,293
Residential mortgages	41,874	1,895	43,769	—	3	—	43,772	7
Personal lending	6,293	686	6,979	—	29	—	7,008	20
Property	19,667	30,152	49,819	4,641	3,668	1	58,129	356
Construction	4,090	2,510	6,600	156	858	45	7,659	477
Manufacturing	11,549	7,440	18,989	377	2,747	—	22,113	1,377
Service industries and business activities	45,825	18,298	64,122	2,843	9,500	—	76,465	1,046
Agriculture, forestry and fishing	815	31	846	—	35	—	881	61
Finance leases and instalment credit	376	48	424	56	16	—	496	—
Interest accruals	629	146	775	451	—	—	1,226	—
Total third-party	216,666	67,434	284,100	133,287	411,680	4,159	833,226	368,102
Amounts due from holding company and subsidiaries	125,736	10,727	136,463	83,010	39,233	—	258,706	—
Total gross of provisions	342,402	78,161	420,563	216,297	450,913	4,159	1,091,932	368,102
Provisions			(4,650)	(674)	—	—	(5,324)	n/a
			415,913	215,623	450,913	4,159	1,086,608	368,102

For notes to this table refer to page 68.

Financial review continued

Risk management: Credit risk continued

Balance sheet analysis: Industry and geography analysis continued

2008	Bank				Total £m	Netting and offset (1) £m
	Loans and advances £m	Securities £m	Derivatives £m	Settlement balances £m		
Total						
Central and local government	4,766	35,040	4,324	4	44,134	352
Finance - banks	54,930	—	—	—	54,930	—
- other	56,418	115,549	836,764	4,776	1,013,507	777,831
Residential mortgages	39,852	—	5	—	39,857	52
Personal lending	7,861	—	6	—	7,867	—
Property	53,270	2,693	4,659	2	60,624	433
Construction	8,269	36	812	—	9,117	405
Manufacturing	29,710	462	6,918	20	37,110	1,904
Service industries and business activities	81,312	5,453	16,099	532	103,396	2,441
Agriculture, forestry and fishing	853	—	33	1	887	71
Finance leases and instalment credit	725	—	25	—	750	—
Interest accruals	2,417	823	—	—	3,240	—
Total third-party	340,383	160,056	869,645	5,335	1,375,419	783,489
Amounts due from holding company and subsidiaries	80,849	708	68,860	—	150,417	—
Total gross of provisions	421,232	160,764	938,505	5,335	1,525,836	783,489
Provisions	(2,475)	(46)	—	—	(2,521)	—
	418,757	160,718	938,505	5,335	1,523,315	783,489

For notes to this table refer to page 68.

Loans and advances to banks and customers by geography.

	Bank		
	2010 £m	2009 £m	2008 £m
Loans and advances to banks (1)			
- UK	57,861	40,766	52,403
- US	257	409	401
- Europe	1,086	255	305
- RoW	1,713	2,405	2,208
Total third-party	60,917	43,835	55,317
Amounts due from subsidiaries	40,127	33,610	36,481
Total loans and advances to banks	101,044	77,445	91,798
Loans and advances to customers			
- UK	193,651	196,247	223,511
- US	7,897	11,522	19,923
- Europe	16,933	21,936	29,037
- RoW	8,383	10,560	12,595
Total third-party	226,864	240,265	285,066
Amounts due from holding company and subsidiaries	127,817	102,853	44,368
Total loans and advances to banks	354,681	343,118	329,434
	455,725	420,563	421,232

Note:

(1) Loans and advances to banks includes £42 million of accrued interest (2009 - £106 million; 2008 - £387 million).

The tables below and on pages 66 to 68 analyse total financial assets by industry sector and geography for the Bank.

2010	Bank							
	Loans and advances			Securities £m	Derivatives £m	Settlement balances £m	Total £m	Netting and offset (1) £m
	Core £m	Non-Core £m	Total £m					
UK								
Central and local government	3,979	140	4,119	69,649	6,977	173	80,918	2,684
Finance - banks	57,822	—	57,822	—	—	—	57,822	—
- other	48,402	2,333	50,735	24,133	237,975	1,934	314,777	249,773
Residential mortgages	42,017	1,665	43,682	14	2	—	43,698	13
Personal lending	5,257	419	5,676	—	1	—	5,677	10
Property	17,214	20,277	37,491	3,006	3,142	28	43,667	427
Construction	3,451	1,164	4,615	39	700	—	5,354	433
Manufacturing	6,428	1,193	7,621	274	1,956	—	9,851	554
Service industries and business activities	30,105	8,381	38,486	1,961	6,773	338	47,558	1,084
Agriculture, forestry and fishing	692	27	719	—	25	—	744	36
Finance leases and instalment credit	201	105	306	10	14	—	330	—
Interest accruals	240	—	240	475	—	—	715	—
Total third-party	215,808	35,704	251,512	99,561	257,565	2,473	611,111	255,014
Amounts due from holding company and subsidiaries	151,816	5,061	156,877	74,726	19,291	—	250,894	—
	367,624	40,765	408,389	174,287	276,856	2,473	862,005	255,014
US								
Central and local government	47	—	47	2,900	5	—	2,952	—
Finance - banks	257	—	257	—	—	—	257	—
- other	437	591	1,028	3,156	121,555	927	126,666	115,223
Property	191	132	323	1	23	—	347	—
Construction	133	7	140	—	16	—	156	—
Manufacturing	1,297	64	1,361	28	583	—	1,972	—
Service industries and business activities	3,122	1,799	4,921	99	2,039	43	7,102	—
Agriculture, forestry and fishing	—	—	—	—	3	—	3	—
Finance leases and instalment credit	56	—	56	—	—	—	56	—
Interest accruals	7	14	21	26	—	—	47	—
Total third-party	5,547	2,607	8,154	6,210	124,224	970	139,558	115,223
Amounts due from holding company and subsidiaries	3,596	131	3,727	—	2,758	—	6,485	—
	9,143	2,738	11,881	6,210	126,982	970	146,043	115,223
Europe								
Central and local government	110	507	617	—	64	—	681	—
Finance - banks	1,063	22	1,085	—	—	—	1,085	—
- other	437	337	774	69	—	—	843	—
Residential mortgages	4	—	4	—	—	—	4	—
Personal lending	1	—	1	—	—	—	1	—
Property	297	2,526	2,823	—	—	—	2,823	—
Construction	235	301	536	—	—	—	536	—
Manufacturing	1,095	3,424	4,519	—	—	—	4,519	—
Service industries and business activities	5,524	2,068	7,592	—	—	—	7,592	—
Agriculture, forestry and fishing	1	—	1	—	—	—	1	—
Finance leases and instalment credit	5	—	5	—	—	—	5	—
Interest accruals	11	51	62	—	—	—	62	—
Total third-party	8,783	9,236	18,019	69	64	—	18,152	—
Amounts due from holding company and subsidiaries	17	1,462	1,479	—	—	—	1,479	—
	8,800	10,698	19,498	69	64	—	19,631	—

For notes to this table refer to page 68.

Financial review continued

Risk management: Credit risk continued

Balance sheet analysis: Industry and geography analysis continued

2010	Loans and advances			Bank			Total £m	Netting and offset (1) £m
	Core £m	Non-Core £m	Total £m	Securities £m	Derivatives £m	Settlement balances £m		
RoW								
Central and local government	381	—	381	6,026	177	—	6,584	—
Finance - banks	1,641	70	1,711	—	—	—	1,711	—
- other	1,694	290	1,984	3,752	25,419	86	31,241	22,420
Residential mortgages	409	—	409	—	—	—	409	—
Personal lending	2	—	2	—	6	—	8	—
Property	540	1,154	1,694	303	68	—	2,065	—
Construction	79	40	119	—	—	—	119	—
Manufacturing	195	236	431	—	210	—	641	—
Service industries and business activities	2,051	1,297	3,348	73	992	—	4,413	—
Agriculture, forestry and fishing	3	—	3	—	2	—	5	—
Interest accruals	13	1	14	15	—	—	29	—
Total third-party	7,008	3,088	10,096	10,169	26,874	86	47,225	22,420
Amounts due from holding company and subsidiaries	5,528	333	5,861	—	2,036	—	7,897	—
	12,536	3,421	15,957	10,169	28,910	86	55,122	22,420
2009								
UK								
Central and local government	2,257	192	2,449	79,263	6,712	4	88,428	465
Finance - banks	40,086	576	40,662	—	—	—	40,662	—
- other	35,916	2,384	38,300	31,460	239,768	3,009	312,537	232,267
Residential mortgages	41,480	1,895	43,375	—	3	—	43,378	7
Personal lending	6,290	686	6,976	—	—	—	6,976	20
Property	18,653	23,406	42,059	3,970	3,588	1	49,618	356
Construction	3,475	1,929	5,404	155	799	45	6,403	477
Manufacturing	7,766	2,452	10,218	345	2,112	—	12,675	1,377
Service industries and business activities	34,547	11,150	45,697	2,704	7,237	—	55,638	1,046
Agriculture, forestry and fishing	812	31	843	—	30	—	873	61
Finance leases and instalment credit	340	29	369	56	16	—	441	—
Interest accruals	597	64	661	420	—	—	1,081	—
Total third-party	192,219	44,794	237,013	118,373	260,265	3,059	618,710	236,076
Amounts due from holding company and subsidiaries	118,235	10,351	128,586	83,010	31,783	—	243,379	—
	310,454	55,145	365,599	201,383	292,048	3,059	862,089	236,076
US								
Central and local government	48	—	48	2,273	9	1	2,331	—
Finance - banks	401	7	408	—	—	—	408	—
- other	386	1,442	1,828	6,220	125,413	1,045	134,506	112,301
Property	505	222	727	2	30	—	759	—
Construction	141	13	154	1	50	—	205	—
Manufacturing	1,881	206	2,087	32	580	—	2,699	—
Service industries and business activities	3,578	3,050	6,628	59	1,868	—	8,555	—
Agriculture, forestry and fishing	—	—	—	—	2	—	2	—
Finance leases and instalment credit	25	—	25	—	—	—	25	—
Interest accruals	10	16	26	30	—	—	56	—
Total third-party	6,975	4,956	11,931	8,617	127,952	1,046	149,546	112,301
Amounts due from holding company and subsidiaries	4,327	59	4,386	—	4,353	—	8,739	—
	11,302	5,015	16,317	8,617	132,305	1,046	158,285	112,301

For notes to this table refer to page 68.

2009	Loans and advances			Bank			Total £m	Netting and offset (1) £m
	Core £m	Non-Core £m	Total £m	Securities £m	Derivatives £m	Settlement balances £m		
Europe								
Central and local government	22	575	597	—	33	—	630	—
Finance - banks	200	54	254	—	—	—	254	—
- other	347	522	869	51	—	—	920	—
Residential mortgages	4	—	4	—	—	—	4	—
Personal lending	1	—	1	—	—	—	1	—
Property	308	4,795	5,103	—	—	—	5,103	—
Construction	461	354	815	—	—	—	815	—
Manufacturing	1,637	4,402	6,039	—	—	—	6,039	—
Service industries and business activities	5,966	2,471	8,437	1	—	—	8,438	—
Finance leases and instalment credit	11	—	11	—	—	—	11	—
Interest accruals	11	50	61	—	—	—	61	—
Total third-party	8,968	13,223	22,191	52	33	—	22,276	—
Amounts due from holding company and subsidiaries	2	162	164	—	—	—	164	—
	8,970	13,385	22,355	52	33	—	22,440	—
RoW								
Central and local government	1,089	—	1,089	3,052	168	3	4,312	—
Finance - banks	2,335	70	2,405	—	—	—	2,405	—
- other	2,462	406	2,868	2,444	22,721	51	28,084	19,725
Residential mortgages	390	—	390	—	—	—	390	—
Personal lending	2	—	2	—	29	—	31	—
Property	201	1,729	1,930	669	50	—	2,649	—
Construction	13	214	227	—	9	—	236	—
Manufacturing	265	380	645	—	55	—	700	—
Service industries and business activities	1,733	1,627	3,360	79	395	—	3,834	—
Agriculture, forestry and fishing	3	—	3	—	3	—	6	—
Finance leases and instalment credit	—	19	19	—	—	—	19	—
Interest accruals	11	16	27	1	—	—	28	—
Total third-party	8,504	4,461	12,965	6,245	23,430	54	42,694	19,725
Amounts due from subsidiaries	3,172	155	3,327	—	3,097	—	6,424	—
	11,676	4,616	16,292	6,245	26,527	54	49,118	19,725
2008								
	Loans and advances			Bank			Total £m	Netting and offset (1) £m
UK	Loans and advances £m	Securities £m	Derivatives £m	Settlement Balances £m	Total £m			
Central and local government	3,559	33,099	4,003	1	40,662	352		
Finance - banks	52,022	—	—	—	52,022	—		
- other	50,474	100,956	448,812	3,462	603,704	426,102		
Residential mortgages	39,409	—	5	—	39,414	52		
Personal lending	7,857	—	6	—	7,863	—		
Property	44,390	2,296	4,509	2	51,197	433		
Construction	6,614	33	687	—	7,334	405		
Manufacturing	16,047	263	5,516	15	21,841	1,904		
Service industries and business activities	52,075	4,787	11,933	478	69,273	2,290		
Agriculture, forestry and fishing	836	—	21	1	858	71		
Finance leases and instalment credit	491	—	25	—	516	—		
Interest accruals	2,140	761	—	—	2,901	—		
Total third-party	275,914	142,195	475,517	3,959	897,585	431,609		
Amounts due from holding company and subsidiaries	70,584	697	53,832	—	125,113	—		
	346,498	142,892	529,349	3,959	1,022,698	431,609		

For notes to this table refer to page 68.

Financial review continued

Risk management: Credit risk continued

Balance sheet analysis: Industry and geography analysis continued

2008	Bank				Total £m	Netting and offset (1) £m
	Loans and advances £m	Securities £m	Derivatives £m	Settlement balances £m		
US						
Central and local government	75	319	45	3	442	—
Finance - banks	400	—	—	—	400	—
- other	2,325	11,611	353,126	1,314	368,376	320,460
Property	1,057	—	97	—	1,154	—
Construction	203	3	123	—	329	—
Manufacturing	3,769	44	1,308	5	5,126	—
Service industries and business activities	12,304	330	3,838	54	16,526	151
Agriculture, forestry and fishing	—	—	2	—	2	—
Finance leases and instalment credit	120	—	—	—	120	—
Interest accruals	71	61	—	—	132	—
Total third-party	20,324	12,368	358,539	1,376	392,607	320,611
Amounts due from holding company and subsidiaries	5,216	—	12,449	—	17,665	—
	25,540	12,368	370,988	1,376	410,272	320,611
Europe						
Central and local government	598	—	8	—	606	—
Finance - banks	302	—	—	—	302	—
- other	1,456	59	—	—	1,515	7
Residential mortgages	4	—	—	—	4	—
Personal lending	1	—	—	—	1	—
Property	5,893	—	—	—	5,893	—
Construction	1,031	—	—	—	1,031	—
Manufacturing	8,862	—	—	—	8,862	—
Service industries and business activities	10,954	—	—	—	10,954	—
Agriculture, forestry and fishing	2	—	—	—	2	—
Finance leases and instalment credit	90	—	—	—	90	—
Interest accruals	149	1	—	—	150	—
Total third-party	29,342	60	8	—	29,410	7
Amounts due from subsidiaries	39	—	—	—	39	—
	29,381	60	8	—	29,449	7
RoW						
Central and local government	534	1,622	268	—	2,424	—
Finance - banks	2,206	—	—	—	2,206	—
- other	2,163	2,934	34,826	—	39,923	31,262
Residential mortgages	439	—	—	—	439	—
Personal lending	3	—	—	—	3	—
Property	1,930	397	53	—	2,380	—
Construction	421	—	2	—	423	—
Manufacturing	1,032	155	94	—	1,281	—
Service industries and business activities	5,979	336	328	—	6,643	—
Agriculture, forestry and fishing	15	—	10	—	25	—
Finance leases and instalment credit	24	—	—	—	24	—
Interest accruals	57	—	—	—	57	—
Total third-party	14,803	5,444	35,581	—	55,828	31,262
Amounts due from holding company and subsidiaries	5,010	—	2,579	—	7,589	—
	19,813	5,444	38,160	—	63,417	31,262

Note:

- (1) This 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 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.

Asset quality

The asset quality analysis presented below is based on the Group's internal asset quality ratings which have ranges for the probability of default, as set out below. Customers are assigned credit grades, based on various credit grading models that reflect the key drivers of default for the customer type. All credit grades across the Group map to both a Group level asset quality scale, used for external financial reporting, and a master grading scale for wholesale exposures used for internal management reporting across portfolios. Debt securities are analysed by external ratings agencies and are therefore excluded from the table below and are set out on pages 74 and 75.

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

2010	Group								
	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
Total									
AQ1	49,827	78,328	117,727	4,079	397,967	23	67,271	6,959	722,181
AQ2	1	90	11,007	1,166	1,413	—	23,005	931	37,613
AQ3	2	1,563	22,105	147	2,334	—	22,137	2,020	50,308
AQ4	1	152	87,275	571	2,182	—	34,470	2,974	127,625
AQ5	3	165	108,049	60	4,046	—	35,105	3,655	151,083
AQ6	3	13	62,948	33	1,003	—	25,177	1,993	91,170
AQ7	1	65	43,511	1	659	—	17,779	969	62,985
AQ8	—	15	15,890	14	289	—	7,456	245	23,909
AQ9	—	13	13,115	2	284	7	3,614	494	17,529
AQ10	—	278	4,470	—	1,359	—	2,203	260	8,570
Balances with holding company and fellow subsidiaries	—	4,848	1,946	—	17,469	—	39	12,479	36,781
Past due	—	7	13,267	2,675	—	—	—	—	15,949
Impaired	—	98	33,693	—	—	—	—	—	33,791
Impairment provision	—	(88)	(16,682)	—	—	—	—	—	(16,770)
	49,838	85,547	518,321	8,748	429,005	30	238,256	32,979	1,362,724
Core									
AQ1	49,827	78,204	96,644	4,079	387,531	23	60,386	6,851	683,545
AQ2	1	89	8,372	1,166	1,051	—	21,980	914	33,573
AQ3	2	1,561	19,029	146	2,149	—	20,104	1,954	44,945
AQ4	1	150	78,569	571	1,813	—	30,882	2,867	114,853
AQ5	3	163	94,885	60	3,617	—	32,259	3,530	134,517
AQ6	3	12	52,095	33	742	—	23,315	1,931	78,131
AQ7	1	64	36,976	1	403	—	16,884	911	55,240
AQ8	—	15	12,859	14	174	—	7,281	244	20,587
AQ9	—	13	9,309	2	121	7	3,173	466	13,091
AQ10	—	277	2,298	—	316	—	1,292	225	4,408
Balances with holding company and fellow subsidiaries	—	4,736	1,888	—	14,434	—	39	12,479	33,576
Past due	—	—	10,664	2,625	—	—	—	—	13,289
Impaired	—	98	12,819	—	—	—	—	—	12,917
Impairment provision	—	(88)	(7,260)	—	—	—	—	—	(7,348)
	49,838	85,294	429,147	8,697	412,351	30	217,595	32,372	1,235,324

For the note to this table refer to page 71.

Financial review continued

Risk management: Credit risk continued Balance sheet analysis: Asset quality continued

	Group								
	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
2010									
Non-Core									
AQ1	—	124	21,083	—	10,436	—	6,885	108	38,636
AQ2	—	1	2,635	—	362	—	1,025	17	4,040
AQ3	—	2	3,076	1	185	—	2,033	66	5,363
AQ4	—	2	8,706	—	369	—	3,588	107	12,772
AQ5	—	2	13,164	—	429	—	2,846	125	16,566
AQ6	—	1	10,853	—	261	—	1,862	62	13,039
AQ7	—	1	6,535	—	256	—	895	58	7,745
AQ8	—	—	3,031	—	115	—	175	1	3,322
AQ9	—	—	3,806	—	163	—	441	28	4,438
AQ10	—	1	2,172	—	1,043	—	911	35	4,162
Balances with holding company and fellow subsidiaries	—	112	58	—	3,035	—	—	—	3,205
Past due	—	7	2,603	50	—	—	—	—	2,660
Impaired	—	—	20,874	—	—	—	—	—	20,874
Impairment provision	—	—	(9,422)	—	—	—	—	—	(9,422)
	—	253	89,174	51	16,654	—	20,661	607	127,400
2009									
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 holding company and fellow subsidiaries	—	5,274	1,949	—	32,020	—	42	20,680	59,965
Past due	—	36	13,979	3,910	40	—	—	—	17,965
Impaired	—	100	27,415	187	—	—	—	—	27,702
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

For the note to this table refer to page 71.

	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	6,803	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 holding company and fellow subsidiaries	—	7,297	4,484	—	56,424	—	51	—	68,256
Past due	—	—	12,797	4,029	11	—	—	—	16,837
Impaired	—	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 £1,958 million (2009 - £2,474 million; 2008 - £2,779 million).

Financial review *continued*

Risk management: Credit risk *continued* Balance sheet analysis: Asset quality *continued*

2010	Bank							
	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
Total								
AQ1	44,916	58,880	64,861	2,237	396,558	46,075	5,600	619,127
AQ2	1	62	5,632	205	1,346	20,809	785	28,840
AQ3	1	869	12,448	75	2,299	17,092	1,671	34,455
AQ4	1	116	35,648	121	2,098	20,297	1,383	59,664
AQ5	1	122	48,142	19	3,702	16,594	1,582	70,162
AQ6	1	6	21,629	24	668	10,470	868	33,666
AQ7	—	21	12,405	1	463	7,543	337	20,770
AQ8	—	8	4,333	14	187	2,727	40	7,309
AQ9	—	9	4,833	2	169	1,964	298	7,275
AQ10	—	272	1,828	—	1,237	1,296	128	4,761
Balances with holding company and subsidiaries	—	40,127	127,817	—	24,085	533	12,479	205,041
Past due	—	—	2,521	831	—	—	—	3,352
Impaired	—	89	12,584	—	—	—	—	12,673
Impairment provision	—	(79)	(5,502)	—	—	—	—	(5,581)
	44,921	100,502	349,179	3,529	432,812	145,400	25,171	1,101,514
Core								
AQ1	44,916	58,796	56,914	2,237	386,212	43,307	5,520	597,902
AQ2	1	61	4,220	205	984	19,819	768	26,058
AQ3	1	867	10,614	74	2,114	15,492	1,608	30,770
AQ4	1	115	30,282	121	1,732	17,251	1,277	50,779
AQ5	1	120	38,736	19	3,279	14,403	1,461	58,019
AQ6	1	5	14,436	24	465	9,207	806	24,944
AQ7	—	21	9,140	1	210	6,883	279	16,534
AQ8	—	8	3,589	14	87	2,632	39	6,369
AQ9	—	9	3,068	2	56	1,602	271	5,008
AQ10	—	271	955	—	278	574	93	2,171
Balances with holding company and subsidiaries	—	40,006	120,952	—	20,680	533	12,479	194,650
Past due	—	—	2,038	781	—	—	—	2,819
Impaired	—	89	3,877	—	—	—	—	3,966
Impairment provision	—	(79)	(2,038)	—	—	—	—	(2,117)
	44,921	100,289	296,783	3,478	416,097	131,703	24,601	1,017,872
Non-Core								
AQ1	—	84	7,947	—	10,346	2,768	80	21,225
AQ2	—	1	1,412	—	362	990	17	2,782
AQ3	—	2	1,834	1	185	1,600	63	3,685
AQ4	—	1	5,366	—	366	3,046	106	8,885
AQ5	—	2	9,406	—	423	2,191	121	12,143
AQ6	—	1	7,193	—	203	1,263	62	8,722
AQ7	—	—	3,265	—	253	660	58	4,236
AQ8	—	—	744	—	100	95	1	940
AQ9	—	—	1,765	—	113	362	27	2,267
AQ10	—	1	873	—	959	722	35	2,590
Balances with holding company and subsidiaries	—	121	6,865	—	3,405	—	—	10,391
Past due	—	—	483	50	—	—	—	533
Impaired	—	—	8,707	—	—	—	—	8,707
Impairment provision	—	—	(3,464)	—	—	—	—	(3,464)
	—	213	52,396	51	16,715	13,697	570	83,642

For the note to this table refer to page 73.

	Bank							
	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
2009								
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 holding company and subsidiaries	—	33,610	102,853	—	39,233	329	20,680	196,705
Past due	—	—	3,431	1,113	39	—	—	4,583
Impaired	—	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 holding company and subsidiaries	—	36,481	44,368	—	68,860	346	—	150,055
Past due	—	—	2,482	1,010	11	—	—	3,503
Impaired	—	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 £463 million (2009 - £426 million; 2008 - £484 million).

Financial review continued

Risk management: Credit risk continued Balance sheet analysis: Debt securities

The table below analyses debt securities by issuer and external ratings.

	Central and local government			Group				Total £m	% of total (2)
	UK £m	US £m	Other £m	Banks and building societies £m	ABS (1) £m	Corporate £m	Other £m		
2010									
Total									
AAA	10,755	31,839	31,493	2,032	38,281	262	17	114,679	69
AA to AA+	—	—	17,215	1,704	3,753	249	—	22,921	14
A to AA-	—	—	5,876	3,242	2,513	522	5	12,158	7
BBB- to A-	—	—	231	684	3,317	1,900	6	6,138	4
Non-investment grade	—	—	315	271	4,913	1,139	3	6,641	4
Unrated	—	—	51	303	1,645	1,260	222	3,481	2
	10,755	31,839	55,181	8,236	54,422	5,332	253	166,018	100
Balances with fellow subsidiaries	—	—	—	—	—	11	—	11	
	10,755	31,839	55,181	8,236	54,422	5,343	253	166,029	
Core									
AAA	10,755	31,544	31,493	2,032	34,570	262	15	110,671	73
AA to AA+	—	—	17,215	1,704	1,074	249	—	20,242	13
A to AA-	—	—	5,876	3,211	1,150	521	5	10,763	7
BBB- to A-	—	—	231	681	1,040	1,853	6	3,811	2
Non-investment grade	—	—	315	271	3,042	886	2	4,516	3
Unrated	—	—	51	302	921	956	210	2,440	2
	10,755	31,544	55,181	8,201	41,797	4,727	238	152,443	100
Non-Core									
AAA	—	295	—	—	3,711	—	2	4,008	29
AA to AA+	—	—	—	—	2,679	—	—	2,679	20
A to AA-	—	—	—	31	1,363	1	—	1,395	10
BBB- to A-	—	—	—	3	2,277	47	—	2,327	17
Non-investment grade	—	—	—	—	1,871	253	1	2,125	16
Unrated	—	—	—	1	724	304	12	1,041	8
	—	295	—	35	12,625	605	15	13,575	100
2009									
Total									
AAA	25,208	19,283	29,421	2,857	44,101	1,376	—	122,246	66
AA to AA+	—	—	18,889	2,987	8,098	532	—	30,506	17
A to AA-	—	—	7,472	2,300	3,794	469	—	14,035	8
BBB- to A-	—	—	823	720	4,172	1,989	—	7,704	4
Non-investment grade	—	—	181	156	3,469	1,401	—	5,207	3
Unrated	—	—	43	231	2,021	1,513	802	4,610	2
	25,208	19,283	56,829	9,251	65,655	7,280	802	184,308	100
Balances with fellow subsidiaries	—	—	—	—	—	873	—	873	
	25,208	19,283	56,829	9,251	65,655	8,153	802	185,181	
2008									
Total									
AAA	18,272	11,360	28,311	6,019	64,622	2,543	—	131,127	74
BBB- to AA+	—	—	7,676	10,678	10,390	5,538	—	34,282	19
Non-investment grade	—	—	31	—	2,793	1,459	—	4,283	2
Unrated	—	—	1	1,335	1,934	4,064	740	8,074	5
	18,272	11,360	36,019	18,032	79,739	13,604	740	177,766	100

	Central and local government			Bank				Total £m	% of total (2)
	UK £m	US £m	Other £m	Banks and building societies £m	ABS (1) £m	Corporate £m	Other £m		
2010									
AAA	10,754	18,325	30,691	1,971	10,902	22	17	72,682	64
AA to AA+	—	—	13,650	1,439	3,555	883	—	19,527	17
A to AA-	—	—	5,870	3,042	1,646	210	5	10,773	10
BBB- to A-	—	—	144	643	2,031	758	6	3,582	3
Non-investment grade	—	—	286	281	2,746	683	—	3,996	3
Unrated	—	—	53	287	1,606	1,783	193	3,922	3
	10,754	18,325	50,694	7,663	22,486	4,339	221	114,482	100
Balances with fellow subsidiaries	—	—	—	—	74,252	474	—	74,726	
	10,754	18,325	50,694	7,663	96,738	4,813	221	189,208	
2009									
AAA	25,206	9,382	28,424	2,433	13,710	741	—	79,896	61
AA to AA+	—	—	13,842	2,678	7,850	566	—	24,936	19
A to AA-	—	—	7,472	2,123	2,558	251	—	12,404	9
BBB- to A-	—	—	806	694	2,766	1,316	—	5,582	4
Non-investment grade	—	—	160	180	2,304	1,006	—	3,650	3
Unrated	—	—	38	230	2,004	2,112	736	5,120	4
	25,206	9,382	50,742	8,338	31,192	5,992	736	131,588	100
Balances with fellow subsidiaries	—	—	—	—	81,492	1,518	—	83,010	
	25,206	9,382	50,742	8,338	112,684	7,510	736	214,598	
2008									
AAA	16,278	2,256	27,016	5,772	62,026	2,725	—	116,073	73
BBB- to AA+	—	—	4,098	10,205	8,421	3,452	—	26,176	17
Non-investment grade	—	—	31	—	2,604	1,321	—	3,956	2
Unrated	—	—	—	1,490	5,842	4,785	668	12,785	8
	16,278	2,256	31,145	17,467	78,893	12,283	668	158,990	100
Balances with fellow subsidiaries	—	—	—	—	—	708	—	708	
	16,278	2,256	31,145	17,467	78,893	12,991	668	159,698	

Notes:

- (1) Asset-backed securities.
(2) Percentage calculated before balances with Group companies.

Risk management: Credit risk *continued*

Balance sheet analysis: Derivatives

The table below analyses the Group's derivative assets by internal credit quality banding and residual maturity. Master netting agreements in respect of mark-to-market (mtm) values and collateral do not result in a net presentation in the Group's balance sheet under IFRS.

	2010					Total £m	2009 Total £m
	0-3 months £m	3-6 months £m	6-12 months £m	1-5 years £m	Over 5 years £m		
AQ1	29,333	10,386	16,053	130,859	211,336	397,967	372,642
AQ2	253	99	149	713	199	1,413	10,574
AQ3	1,121	337	549	185	142	2,334	10,287
AQ4	532	111	145	1,222	172	2,182	5,697
AQ5	553	70	163	1,272	1,988	4,046	5,895
AQ6	122	42	63	615	161	1,003	2,286
AQ7	138	13	36	270	202	659	1,931
AQ8	2	1	5	87	194	289	1,247
AQ9	14	5	38	72	155	284	1,788
AQ10	13	11	43	324	968	1,359	1,946
Accruing past due	—	—	—	—	—	—	40
	32,081	11,075	17,244	135,619	215,517	411,536	414,333
Balances with Group companies	1,013	441	808	6,961	8,246	17,469	32,020
Group	33,094	11,516	18,052	142,580	223,763	429,005	446,353
Counterparty mtm netting						(327,725)	(352,492)
Cash collateral held against derivative exposures (1)						(29,556)	(28,454)
Net exposure						71,724	65,407

The tables below analyse the Group's derivative assets by contract type and residual maturity and the effect of position netting and collateral.

Contract type	Group					Gross assets £m	Counterparty mtm netting £m	Net exposure £m
	0 - 3 months £m	3 - 6 months £m	6 - 12 months £m	1 - 5 years £m	Over 5 years £m			
2010								
Exchange rate	28,081	7,516	9,018	22,318	13,385	80,318	(68,972)	11,346
Interest rate	3,855	3,423	7,703	99,972	189,449	304,402	(235,306)	69,096
Credit derivatives	56	98	290	12,133	12,592	25,169	(21,800)	3,369
Equity and commodity	89	38	233	1,196	91	1,647	(1,647)	—
	32,081	11,075	17,244	135,619	215,517	411,536	(327,725)	83,811
Balances with Group companies	1,013	441	808	6,961	8,246	17,469	—	17,469
	33,094	11,516	18,052	142,580	223,763	429,005	(327,725)	101,280
Cash collateral held against derivative exposures (1)								(29,556)
Net exposure								71,724
2009								
Exchange rate	17,617	5,431	6,974	21,300	10,606	61,928	(46,268)	15,660
Interest rate	8,445	8,384	16,273	104,611	173,907	311,620	(269,466)	42,154
Credit derivatives	79	113	388	19,156	19,588	39,324	(35,297)	4,027
Equity and commodity	38	65	295	800	263	1,461	(1,461)	—
	26,179	13,993	23,930	145,867	204,364	414,333	(352,492)	61,841
Balances with Group companies	2,272	1,434	2,215	11,748	14,351	32,020	—	32,020
	28,451	15,427	26,145	157,615	218,715	446,353	(352,492)	93,861
Cash collateral held against derivative exposures (1)								(28,454)
Net exposure								65,407
2008								
Exchange rate	57,816	19,090	21,836	33,585	14,164	146,491	(104,177)	42,314
Interest rate	12,840	16,765	21,872	171,607	382,740	605,824	(570,909)	34,915
Credit derivatives	726	318	1,932	67,099	44,661	114,736	(90,885)	23,851
Equity and commodity	3,593	1,927	3,259	4,926	277	13,982	(9,921)	4,061
	74,975	38,100	48,899	277,217	441,842	881,033	(775,892)	105,141
Balances with Group companies	8,211	2,140	2,822	19,033	24,218	56,424	—	56,424
	83,186	40,240	51,721	296,250	466,060	937,457	(775,892)	161,565

Note:

(1) As at 31 December 2010, in addition to cash collateral the Group holds collateral in the form of securities of £2.9 billion (2009 - £3.6 billion) against derivative positions.

Risk management: Credit risk *continued*

Balance sheet analysis: Cross border exposures

Cross border exposures are loans and advances including finance leases and instalment credit receivables and other monetary assets, such as debt securities and net derivatives, including non-local currency claims of overseas offices on local residents.

The Group monitors the geographical breakdown of these exposures based on the country of domicile of the borrower or guarantor of ultimate risk. Cross border exposures exclude exposures to local residents in local currencies.

The table below sets out the Group's cross border exposures greater than 0.5% of the Group's total assets. None of these countries have experienced repayment difficulties that have required restructuring of outstanding debt.

	2010				2009 Total £m	2008 Total £m
	Government £m	Banks £m	Other £m	Total £m		
US	19,214	12,944	22,730	54,888	53,081	50,787
France	14,903	15,383	3,377	33,663	24,192	22,605
Germany	17,213	4,553	7,699	29,465	24,922	22,689
Netherlands	2,874	1,905	6,664	11,443	14,701	19,363
Japan	7,585	1,665	668	9,918	9,878	9,668
Spain	1,315	1,753	6,755	9,823	10,749	16,919
Italy	5,532	547	922	7,001	7,713	8,567
Cayman Islands	—	—	4,935	4,935	7,990	11,486
Republic of Ireland	102	3,519	1,108	4,729	9,381	8,451

REIL, provisions and reserves

All the disclosures in this section (pages 79 to 90) are audited. The Group classifies impaired assets as either risk elements in lending (REIL) or potential problem loans (PPL). REIL represents impairment loans and loans that are accruing but are past due 90 days. 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 analysis of risk elements in lending and impairments below, form a key part of the data provided to senior management on the credit performance of the Group's portfolios.

The table below analyses the Group's REIL and PPL and takes no account of the value of any security held which could reduce the eventual loss should it occur, nor of any provisions

	2010			2009			2008
	Core £m	Non-Core £m	Group £m	Core £m	Non-Core £m	Group £m	Group £m
Impaired loans (1)							
UK	7,892	7,731	15,623	6,465	6,936	13,401	8,246
Overseas	5,025	13,143	18,168	3,461	10,653	14,114	5,480
	12,917	20,874	33,791	9,926	17,589	27,515	13,726
Accruing loans past due 90 days or more (2)							
UK	1,436	939	2,375	1,148	1,089	2,237	1,182
Overseas	216	248	464	135	697	832	487
	1,652	1,187	2,839	1,283	1,786	3,069	1,669
Total REIL	14,569	22,061	36,630	11,209	19,375	30,584	15,395
Potential problem loans (3)	436	76	512	137	293	430	226
Total REIL and PPL	15,005	22,137	37,142	11,346	19,668	31,014	15,621
REIL as a % of gross loans to customers (4)	3.8%	21.9%	7.5%	2.9%	15.0%	5.9%	2.6%
REIL and PPL as a % of gross loans to customers (4)	3.9%	21.9%	7.6%	2.9%	15.2%	6.0%	2.6%
Closing provision for impairment as a % of total REIL	50%	43%	46%	54%	31%	39%	43%
Closing provision for impairment as a % of total REIL and PPL	49%	43%	45%	53%	30%	39%	43%

Notes:

(1) All loans against which an impairment provision is held.

(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 advances and revolving credit facilities where the past due concept is not applicable.

(4) Includes gross loans to disposal groups but excludes reverse repos and intercompany loans.

Financial review continued

Risk management: Credit risk continued REIL, provisions and reserves continued Movement in REIL and PPL

The table below details the movement in REIL and PPL for the year ended 31 December 2010.

	REIL			Group PPL			Total		
	Core £m	Non-Core £m	Group £m	Core £m	Non-Core £m	Group £m	Core £m	Non-Core £m	Group £m
At 1 January 2010	11,209	19,375	30,584	137	293	430	11,346	19,668	31,014
Intra-group transfers	(140)	140	—	147	(147)	—	7	(7)	—
Currency translation and other adjustments	3	(208)	(205)	—	1	1	3	(207)	(204)
Additions	11,263	11,348	22,611	651	185	836	11,914	11,533	23,447
Transfers	(2)	22	20	(13)	(22)	(35)	(15)	—	(15)
Disposals, restructurings and repayments	(4,989)	(6,018)	(11,007)	(486)	(234)	(720)	(5,475)	(6,252)	(11,727)
Amounts written-off	(2,775)	(2,598)	(5,373)	—	—	—	(2,775)	(2,598)	(5,373)
At 31 December 2010	14,569	22,061	36,630	436	76	512	15,005	22,137	37,142

Past due analysis

The following loans and advances to customers were past due at the balance sheet date but not considered impaired:

	2010			2009 Group £m	2008 Group £m
	Core £m	Non-Core £m	Group £m		
Past due 1-29 days	6,391	788	7,179	6,272	7,851
Past due 30-59 days	1,710	377	2,087	2,252	2,138
Past due 60-89 days	911	251	1,162	2,386	1,139
Past due 90 days or more	1,652	1,187	2,839	3,069	1,669
	10,664	2,603	13,267	13,979	12,797

Note:

- (1) The amounts shown above 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, REIL and impairments by industry and geography

The tables below analyse gross loans and advances to customers (excluding reverse repos and disposal groups), REIL, provisions, impairment charges and amounts written-off relating to these loans, by industry and geography (by location of office) for the Group.

2010	Group							
	Gross loans £m	REIL £m	Provisions £m	REIL as a % of gross loans	Provisions as a % of REIL	Provisions as a % gross loans	Impairment charge £m	Amounts written-off £m
Total								
Central and local government	7,140	—	—	—	—	—	—	—
Finance								
- banks	42,163	98	88	0.2	90	0.2	—	—
- other	46,740	637	278	1.4	44	0.6	147	102
Residential mortgages	145,677	4,230	854	2.9	20	0.6	1,008	668
Personal lending	36,004	3,340	2,733	9.3	82	7.6	1,244	1,442
Property	89,015	19,487	6,677	21.9	34	7.5	4,658	1,011
Construction	11,255	2,457	867	21.8	35	7.7	527	144
Manufacturing	24,740	836	276	3.4	33	1.1	105	149
Service industries and business activities	101,859	4,558	1,858	4.5	41	1.8	1,215	740
Agriculture, forestry and fishing	3,751	140	84	3.7	60	2.2	30	6
Finance leases and instalment credit	16,803	847	555	5.0	66	3.3	252	113
Interest accruals	965	—	—	—	—	—	—	—
Latent	—	—	2,500	—	—	—	113	—
Total third-party	526,112	36,630	16,770	7.0	46	3.2	9,299	4,375
Amounts due from fellow subsidiaries	6,794	—	—	—	—	—	—	—
	532,906	36,630	16,770	6.9	46	3.1	9,299	4,375
of which:								
UK	368,647	17,998	8,494	4.9	47	2.3	4,023	2,264
Europe	69,100	15,194	6,343	22.0	42	9.2	4,069	305
US	73,951	2,195	1,567	3.0	71	2.1	1,072	1,606
RoW	14,414	1,243	366	8.6	29	2.5	135	200
Total third-party	526,112	36,630	16,770	7.0	46	3.2	9,299	4,375
Amounts due from fellow subsidiaries	6,794	—	—	—	—	—	—	—
	532,906	36,630	16,770	6.9	46	3.1	9,299	4,375

Financial review continued

Risk management: Credit risk continued REIL, provisions and reserves continued Loans, REIL and impairments by industry and geography continued

2009	Group							
	Gross loans £m	REIL £m	Provisions £m	REIL as a % of gross loans %	Provisions as a % of REIL %	Provisions as a % gross loans %	Impairment charge £m	Amounts written-off £m
Total								
Central and local government	6,547	—	—	—	—	—	—	—
Finance								
- banks	32,311	100	90	0.3	90	0.3	8	—
- other	45,823	1,022	150	2.2	15	0.3	510	437
Residential mortgages	140,199	3,245	548	2.3	17	0.4	909	640
Personal lending	39,340	3,577	2,767	9.1	77	7.0	2,150	1,670
Property	98,131	14,219	3,356	14.5	24	3.4	3,241	632
Construction	13,948	2,200	501	15.8	23	3.6	471	287
Manufacturing	30,835	713	345	2.3	48	1.1	898	752
Service industries and business activities	112,133	4,492	1,423	4.0	32	1.3	1,785	1,159
Agriculture, forestry and fishing	4,031	122	62	3.0	51	1.5	21	4
Finance leases and instalment credit	20,086	894	417	4.5	47	2.1	270	135
Interest accruals	1,381	—	—	—	—	—	—	—
Latent	—	—	2,361	—	—	—	1,110	—
Total third-party	544,765	30,584	12,020	5.6	39	2.2	11,373	5,716
Amounts due from holding company and fellow subsidiaries	7,223	—	—	—	—	—	—	—
	551,988	30,584	12,020	5.5	39	2.2	11,373	5,716
of which:								
UK	368,556	15,638	6,841	4.2	44	1.9	5,416	2,734
Europe	77,571	10,709	2,918	13.8	27	3.8	2,442	299
US	80,516	3,629	1,816	4.5	50	2.3	3,127	2,587
RoW	18,122	608	445	3.4	73	2.5	388	96
Total third-party	544,765	30,584	12,020	5.6	39	2.2	11,373	5,716
Amounts due from holding company and fellow subsidiaries	7,223	—	—	—	—	—	—	—
	551,988	30,584	12,020	5.5	39	2.2	11,373	5,716

2010	Group							
	Gross loans £m	REIL £m	Provisions £m	REIL as a % of gross loans %	Provisions as a % of REIL %	Provisions as a % gross loans %	Impairment charge £m	Amounts written-off £m
Core								
Central and local government	6,473	—	—	—	—	—	—	—
Finance								
- banks	42,022	98	88	0.2	90	0.2	—	—
- other	39,619	304	210	0.8	69	0.5	119	21
Residential mortgages	140,351	3,998	691	2.8	17	0.5	578	242
Personal lending	32,552	3,126	2,535	9.6	81	7.8	1,147	1,272
Property	41,934	3,278	813	7.8	25	1.9	743	99
Construction	8,163	603	213	7.4	35	2.6	190	39
Manufacturing	19,271	370	147	1.9	40	0.8	119	67
Service industries and business activities	84,652	2,464	903	2.9	37	1.1	720	333
Agriculture, forestry and fishing	3,618	84	49	2.3	58	1.4	24	5
Finance leases and instalment credit	8,273	244	141	2.9	58	1.7	63	42
Interest accruals	745	—	—	—	—	—	—	—
Latent	—	—	1,559	—	—	—	178	—
Total third-party	427,673	14,569	7,349	3.4	50	1.7	3,881	2,120
Amounts due from fellow subsidiaries	6,624	—	—	—	—	—	—	—
	434,297	14,569	7,349	3.4	50	1.7	3,881	2,120
of which:								
UK	307,952	9,328	4,785	3.0	51	1.6	2,229	1,520
Europe	47,528	3,382	1,483	7.1	44	3.1	1,014	45
US	60,916	1,001	822	1.6	82	1.3	457	550
RoW	11,277	858	259	7.6	30	2.3	181	5
Total third-party	427,673	14,569	7,349	3.4	50	1.7	3,881	2,120
Amounts due from fellow subsidiaries	6,624	—	—	—	—	—	—	—
	434,297	14,569	7,349	3.4	50	1.7	3,881	2,120

Financial review continued

Risk management: Credit risk continued REIL, provisions and reserves continued Loans, REIL and impairments by industry and geography continued

2009	Group							
	Gross loans £m	REIL £m	Provisions £m	REIL as a % of gross loans %	Provisions as a % of REIL %	Provisions as a % gross loans %	Impairment charge £m	Amounts written-off £m
Core								
Central and local government	5,739	—	—	—	—	—	—	—
Finance								
- banks	32,006	100	90	0.3	90	0.3	8	—
- other	37,292	600	87	1.6	15	0.2	43	43
Residential mortgages	127,867	2,670	339	2.1	13	0.3	306	146
Personal lending	34,172	3,340	2,556	9.8	77	7.5	1,811	1,384
Property	48,505	1,767	459	3.6	26	0.9	420	37
Construction	9,039	450	124	5.0	28	1.4	57	30
Manufacturing	22,174	298	74	1.3	25	0.3	95	86
Service industries and business activities	88,054	1,602	524	1.8	33	0.6	486	345
Agriculture, forestry and fishing	3,545	79	38	2.2	48	1.1	19	3
Finance leases and instalment credit	8,140	303	116	3.7	38	1.4	51	100
Interest accruals	1,083	—	—	—	—	—	—	—
Latent	—	—	1,660	—	—	—	926	—
Total third-party	417,616	11,209	6,067	2.7	54	1.5	4,222	2,174
Amounts due from holding company and fellow subsidiaries	7,145	—	—	—	—	—	—	—
	424,761	11,209	6,067	2.6	54	1.4	4,222	2,174
of which:								
UK	292,244	7,613	4,290	2.6	56	1.5	2,836	1,600
Europe	49,363	2,221	862	4.5	39	1.7	539	22
US	62,398	1,258	805	2.0	64	1.3	751	552
RoW	13,611	117	110	0.9	94	0.8	96	—
Total third-party	417,616	11,209	6,067	2.7	54	1.5	4,222	2,174
Amounts due from holding company and fellow subsidiaries	7,145	—	—	—	—	—	—	—
	424,761	11,209	6,067	2.6	54	1.4	4,222	2,174

2010	Group							
	Gross loans £m	REIL £m	Provisions £m	REIL as a % of gross loans %	Provisions as a % of REIL %	Provisions as a % gross loans %	Impairment charge £m	Amounts written-off £m
Non-Core								
Central and local government	667	—	—	—	—	—	—	—
Finance								
- banks	141	—	—	—	—	—	—	—
- other	7,121	333	68	4.7	20	1.0	28	81
Residential mortgages	5,326	232	163	4.4	70	3.1	430	426
Personal lending	3,452	214	198	6.2	93	5.7	97	170
Property	47,081	16,209	5,864	34.4	36	12.5	3,915	912
Construction	3,092	1,854	654	60.0	35	21.2	337	105
Manufacturing	5,469	466	129	8.5	28	2.4	(14)	82
Service industries and business activities	17,207	2,094	955	12.2	46	5.6	495	407
Agriculture, forestry and fishing	133	56	35	42.1	63	26.3	6	1
Finance leases and instalment credit	8,530	603	414	7.1	69	4.9	189	71
Interest accruals	220	—	—	—	—	—	—	—
Latent	—	—	941	—	—	—	(65)	—
Total third-party	98,439	22,061	9,421	22.4	43	9.6	5,418	2,255
Amounts due from fellow subsidiaries	170	—	—	—	—	—	—	—
	98,609	22,061	9,421	22.4	43	9.6	5,418	2,255
of which:								
UK	60,694	8,670	3,709	14.3	43	6.1	1,794	744
Europe	21,572	11,812	4,860	54.8	41	22.5	3,055	260
US	13,036	1,194	745	9.2	62	5.7	615	1,056
RoW	3,137	385	107	12.3	28	3.4	(46)	195
Total third-party	98,439	22,061	9,421	22.4	43	9.6	5,418	2,255
Amounts due from fellow subsidiaries	170	—	—	—	—	—	—	—
	98,609	22,061	9,421	22.4	43	9.6	5,418	2,255

Financial review continued

Risk management: Credit risk continued REIL, provisions and reserves continued Loans, REIL and impairments by industry and geography continued

2009	Group							
	Gross loans £m	REIL £m	Provisions £m	REIL as a % of gross loans %	Provisions as a % of REIL %	Provisions as a % of gross loans %	Impairment charge £m	Amounts written-off £m
Non-Core								
Central and local government	808	—	—	—	—	—	—	—
Finance								
- banks	305	—	—	—	—	—	—	—
- other	8,531	422	63	4.9	15	0.7	467	394
Residential mortgages	12,332	575	209	4.7	36	1.7	603	494
Personal lending	5,168	237	211	4.6	89	4.1	339	285
Property	49,626	12,452	2,897	25.1	23	5.8	2,821	596
Construction	4,909	1,750	377	35.6	22	7.7	414	257
Manufacturing	8,661	415	271	4.8	65	3.1	803	666
Service industries and business activities	24,079	2,890	899	12.0	31	3.7	1,299	814
Agriculture, forestry and fishing	486	43	24	8.8	56	4.9	2	1
Finance leases and instalment credit	11,946	591	301	4.9	51	2.5	219	35
Interest accruals	298	—	—	—	—	—	—	—
Latent	—	—	701	—	—	—	184	—
Total third-party	127,149	19,375	5,953	15.2	31	4.7	7,151	3,542
Amounts due from holding company and fellow subsidiaries	78	—	—	—	—	—	—	—
	127,227	19,375	5,953	15.2	31	4.7	7,151	3,542
of which:								
UK	76,312	8,025	2,551	10.5	32	3.3	2,580	1,134
Europe	28,208	8,488	2,056	30.1	24	7.3	1,903	277
US	18,118	2,371	1,011	13.1	43	5.6	2,376	2,035
RoW	4,511	491	335	10.9	68	7.4	292	96
Total third-party	127,149	19,375	5,953	15.2	31	4.7	7,151	3,542
Amounts due from holding company and fellow subsidiaries	78	—	—	—	—	—	—	—
	127,227	19,375	5,953	15.2	31	4.7	7,151	3,542

Risk elements in lending and potential problem loans by division

The tables below analyse the Group's loans and advances to banks and customers (excluding reverse repos and disposal groups) and related REIL, PPL, provisions, impairments, amounts written-off and related ratios by division.

	Group									
	Gross loans £m	REIL £m	PPL £m	REIL & PPL £m	Provisions £m	Provisions as a % of REIL %	Provisions as a % of REIL and PPL %	REIL & PPL as a % of gross loans %	Impairment charge £m	Amounts written-off £m
2010										
UK Retail	108,812	4,620	175	4,795	2,741	59	57	4.4	1,160	1,135
UK Corporate	111,504	3,967	221	4,188	1,732	44	41	3.8	761	349
Wealth	18,350	223	38	261	66	30	25	1.4	18	9
Global Transaction Services	8,170	78	—	78	91	117	117	1.0	14	16
Ulster Bank	39,786	3,619	2	3,621	1,633	45	45	9.1	1,161	48
US Retail & Commercial	48,662	913	—	913	505	55	55	1.9	483	547
Retail & Commercial	335,284	13,420	436	13,856	6,768	50	49	4.1	3,597	2,104
Global Banking & Markets	92,972	1,149	—	1,149	581	51	51	1.2	284	16
Other	(583)	—	—	—	—	—	—	—	—	—
Core	427,673	14,569	436	15,005	7,349	50	49	3.5	3,881	2,120
Non-Core	98,439	22,061	76	22,137	9,421	43	43	22.5	5,418	2,255
Total third-party	526,112	36,630	512	37,142	16,770	46	45	7.1	9,299	4,375
Amounts due from fellow subsidiaries	6,794	—	—	—	—	—	—	—	—	—
	532,906	36,630	512	37,142	16,770	46	45	7.0	9,299	4,375
2009										
UK Retail	103,494	4,641	—	4,641	2,677	58	58	4.5	1,679	1,150
UK Corporate	111,296	2,330	97	2,427	1,271	55	52	2.2	923	352
Wealth	15,525	218	38	256	55	25	21	1.6	33	12
Global Transaction Services	7,322	85	—	85	92	108	108	1.2	16	22
Ulster Bank	42,344	2,260	2	2,262	962	43	43	5.3	649	34
US Retail & Commercial	48,936	643	—	643	478	74	74	1.3	702	546
Retail & Commercial	328,917	10,177	137	10,314	5,535	54	54	3.1	4,002	2,116
Global Banking & Markets	89,222	1,032	—	1,032	532	52	52	1.2	220	58
Other	(523)	—	—	—	—	—	—	—	—	—
Core	417,616	11,209	137	11,346	6,067	54	53	2.7	4,222	2,174
Non-Core	127,149	19,375	293	19,668	5,953	31	30	15.5	7,151	3,542
Total third-party	544,765	30,584	430	31,014	12,020	39	39	5.7	11,373	5,716
Amounts due from holding company and fellow subsidiaries	7,223	—	—	—	—	—	—	—	—	—
	551,988	30,584	430	31,014	12,020	39	39	5.6	11,373	5,716

Risk management: Credit risk continued **REIL, provisions and reserves** continued

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. It incorporates loss experience adjustments, where appropriate, in the light of current economic and credit conditions. These include review of current cash collections profile performance against historic trends, updates to metric inputs - including model recalibrations and monitoring of operational processes used in managing exposure - including the time taken to process non-performing exposures; and
- Latent loss provisions: provisions held against impairments in the performing portfolio that have been incurred as a result of events occurring before the balance sheet date but which have not been identified at the balance sheet date. The Group 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 or proceeds are estimated using two parameters: loss given default (LGD) - this is the estimated 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 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.

- Once a loss event has occurred, a loan is assessed for an impairment provision. In the case of loans that are restructured due to the financial condition of the borrower, the loss event and consequent loan impairment provision assessment (based on management's best estimate of the incurred loss) almost invariably take place prior to the restructuring. The quantum of the loan impairment provision may change once the terms of the restructuring are known resulting in an additional provision charge or a release of provision in the period in which the restructuring takes place.

Provisions and AFS reserves

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

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

Analyses of provisions are set out on pages 89 to 90.

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

Impairment losses 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. 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 macroeconomic outlook in the US and Europe. The underlying securities remain unimpaired.

The analysis of AFS debt securities and related AFS reserves are set out on page 90.

Movement in loan impairment provisions

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

2010	UK Retail £m	UK Corporate £m	Wealth £m	GTS (1) £m	Ulster Bank £m	US R&C (2) £m	Total R&C (2) £m	GBM (3) £m	Total Core £m	Non-Core £m	Group £m
At 1 January	2,677	1,271	55	92	962	478	5,535	532	6,067	5,953	12,020
Intra-group transfers	—	—	—	—	(351)	—	(351)	(217)	(568)	568	—
Transfer to disposal groups	—	—	—	—	—	—	—	—	—	(72)	(72)
Currency translation and other adjustments	—	71	4	—	(22)	19	72	2	74	(79)	(5)
Disposal of subsidiaries	—	—	—	—	—	—	—	—	—	(13)	(13)
Amounts written-off	(1,135)	(349)	(9)	(16)	(48)	(547)	(2,104)	(16)	(2,120)	(2,255)	(4,375)
Recoveries of amounts previously written-off	128	8	—	1	1	72	210	2	212	148	360
Charged to the income statement	1,160	761	18	14	1,161	483	3,597	284	3,881	5,418	9,299
Unwind of discount	(89)	(30)	(2)	—	(70)	—	(191)	(6)	(197)	(247)	(444)
At 31 December	2,741	1,732	66	91	1,633	505	6,768	581	7,349	9,421	16,770
Individually assessed											
- banks	—	—	2	7	—	—	9	79	88	—	88
- customers	—	546	57	55	502	56	1,216	348	1,564	7,453	9,017
Collectively assessed	2,526	689	—	14	733	177	4,139	—	4,139	1,027	5,166
Latent	215	497	7	15	398	272	1,404	154	1,558	941	2,499
	2,741	1,732	66	91	1,633	505	6,768	581	7,349	9,421	16,770
2009											
At 1 January	2,086	696	34	43	491	298	3,648	431	4,079	2,576	6,655
Currency translation and other adjustments	67	5	1	53	(109)	(34)	(17)	(61)	(78)	(165)	(243)
Amounts written-off	(1,150)	(352)	(12)	(22)	(34)	(546)	(2,116)	(58)	(2,174)	(3,542)	(5,716)
Recoveries of amounts previously written-off	97	20	—	2	1	58	178	2	180	127	307
Charged to the income statement	1,679	923	33	16	649	702	4,002	220	4,222	7,151	11,373
Unwind of discount	(102)	(21)	(1)	—	(36)	—	(160)	(2)	(162)	(194)	(356)
At 31 December	2,677	1,271	55	92	962	478	5,535	532	6,067	5,953	12,020
Individually assessed											
- banks	—	—	2	8	—	—	10	80	90	—	90
- customers	—	205	44	59	280	14	602	207	809	4,106	4,915
Collectively assessed	2,475	475	—	17	412	130	3,509	—	3,509	1,145	4,654
Latent	202	591	9	8	270	334	1,414	245	1,659	702	2,361
	2,677	1,271	55	92	962	478	5,535	532	6,067	5,953	12,020

Notes:

- (1) Global Transaction Services.
- (2) Retail & Commercial.
- (3) Global Banking & Markets.

Financial review continued

Risk management: Credit risk continued REIL, provisions and reserves continued Analysis of loan impairment charge

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

	2010 £m	2009 £m	2008 £m
New impairment losses	9,760	12,481	4,917
Less: recoveries of amounts previously written off	(360)	(307)	(211)
Charge to income statement	9,400	12,174	4,706

The following table analyses impairment losses.

	2010 £m	2009 £m	2008 £m
Latent loss	113	1,110	582
Collectively assessed	2,983	3,921	2,183
Individually assessed	6,203	6,334	1,709
Loans to customers	9,299	11,365	4,474
Loans to banks	—	8	81
Securities	101	801	151
Charge to income statement	9,400	12,174	4,706

Charge relating to customer loans as a % of gross customer loans (1)	1.9%	2.2%	1.0%
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Note:

(1) Gross of provisions, including gross loans relating to disposal groups and excluding reverse repurchase agreements and intercompany loans.

	2010			2009			2008 Group £m
	Core £m	Non-Core £m	Group £m	Core £m	Non-Core £m	Group £m	
Loan impairment losses							
- customers	3,881	5,418	9,299	4,214	7,151	11,365	4,474
- banks	—	—	—	8	—	8	81
	3,881	5,418	9,299	4,222	7,151	11,373	4,555
Impairment losses on securities							
- debt securities	40	31	71	96	507	603	71
- equity securities	3	27	30	5	193	198	80
	43	58	101	101	700	801	151
Charge to income statement	3,924	5,476	9,400	4,323	7,851	12,174	4,706

Available-for-sale debt securities and related reserves

The table below analyses available-for-sale (AFS) debt securities by issuer and related AFS reserves for countries exceeding £0.5 billion, together with the total of those individually less than £0.5 billion.

2010	Group				AFS reserves £m
	Government £m	ABS £m	Other £m	Total £m	
US	15,912	20,720	325	36,957	847
UK	5,651	3,444	1,017	10,112	(36)
Germany	4,889	212	154	5,255	(14)
Japan	4,257	—	81	4,338	—
France	3,559	38	619	4,216	77
Australia	—	460	1,140	1,600	(20)
Netherlands	425	640	314	1,379	(5)
Switzerland	657	—	129	786	9
Singapore	467	—	189	656	—
Luxembourg	253	78	188	519	21
Other (individually < £0.5 billion)	305	704	610	1,619	(36)
Group	36,375	26,296	4,766	67,437	843

Market risk

All the disclosures in this section (pages 91 to 94) are audited.

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 value-at-risk (VaR), stress testing, position and sensitivity analyses.

The majority of market risk exposure is in GBM and Non-Core. The RBS Group is also exposed to market risk through interest rate risk on its non-trading activities. There are additional non-trading market risks in the Retail and Commercial businesses of the Group, principally interest rate risk and foreign exchange risk. These aspects are discussed in more detail in Balance sheet management - Interest rate risk on page 40 and structural foreign currency exposures on page 41.

Organisation and structure

The Executive Risk Forum approves market risk appetite for trading and non-trading activities. The Global Head of Market & Insurance Risk is responsible for the Group Market Risk Control Framework and under delegated authority from the Executive Risk Forum, sets a limit framework within the context of the approved market risk appetite, which is cascaded down through legal entity, division, business and desk level market risk limits.

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

The head of each business, assisted by the business risk management team, is accountable for all market risks associated with its activities. Oversight and support is provided to the business by the Global Head of Market & Insurance Risk, assisted by the Group and business Market Risk teams. The Global Market Risk Committee reviews and makes recommendations concerning the market risk profile across the RBS Group, including risk appetite, limits and utilisation. The Committee meets monthly and is chaired by the Global Head of Market Risk & Insurance Risk. Attendees include respective business Risk Managers and Group Market Risk.

Risk measurement and control

At the RBS Group level, the risk appetite is expressed in the form of a combination of VaR, sensitivity and stress testing 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 a confidence level of 99%. The RBS Group's VaR model is based on a historical simulation model, utilising data from the previous two years.

The VaR model has been approved by the FSA to calculate regulatory capital for the trading book. The approval covers general market risk in interest rate, foreign exchange, equity and limited commodity products and specific risk in interest rate and equity products.

As the VaR model is an important market risk measurement and control tool and is used for determining a significant component of the market risk capital, it is regularly assessed. The main approach employed is the technique known as back-testing which counts the number of days when a loss (as defined by the FSA), exceeds the corresponding daily VaR estimate, measured at a 99% confidence interval. The FSA categorises a VaR model as green, amber or red. A green model is consistent with a good working model and is achieved for models that have four or less backtesting exceptions in a 12 month period. For the Group's trading book, a green model status was maintained throughout 2010.

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

- Historical Simulation VaR may not provide the best estimate of future market movements. It can only provide a prediction of the future based on events that occurred in the 500 trading day time series. Therefore, events that are more severe than those in the historical data series cannot be predicted.
- The use of a 99% confidence level does not reflect the extent of potential losses beyond that percentile.
- The use of a one-day time horizon will not fully capture the profit and loss implications of positions that cannot be liquidated or hedged within one day.
- The Group computes the VaR of trading portfolios at the close of business. Positions may change substantially during the course of the trading day and intra-day profit and losses will be incurred.

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

A risk not in VaR framework has been developed to quantify 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.

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 extreme market events. Stress testing measures the impact of exceptional 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.

Risk management: Market risk *continued* **Risk measurement and control** *continued*

The Global Market Risk Stress Testing Committee reviews and discusses all matters relating to Market Risk Stress Testing. Stress test exposures are discussed with senior management and relevant information is reported to the Group Risk Committee, Executive Risk Forum and the Board. Breaches in the 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 the Group Model Product Review Committee (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 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 the 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 Quantitative Research Centre (QuaRC), 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 RBS 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.

As part of the ongoing review and analysis of the suitability of the VaR model, a methodology enhancement to the ABS VaR was approved and incorporated into the regulatory model in 2010. The credit crisis in 2007-2009 caused large price changes for some structured bonds and the spread based approach to calculating VaR for these instruments started to give inaccurate risk levels, particularly for bonds trading at a significant discount to par. The methodology enhancement harmonised the VaR approach in the US and Europe by replacing the absolute spread-based approach with a more reliable and granular relative price-based mapping scheme. The enhancement better reflects the risk in the context of position changes, downgrades and vintage as well as improving differentiation between prime, Alt-A and sub-prime exposures.

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

Traded portfolios

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

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 table below analyses the VaR for the Group's trading portfolios segregated by type of market risk exposure.

Trading VaR	2010				2009			
	Average £m	Period end £m	Maximum £m	Minimum £m	Average £m	Period end £m	Maximum £m	Minimum £m
Interest rate	51.0	54.5	80.9	32.2	57.4	50.3	108.2	29.0
Credit spread	161.7	130.6	237.0	109.0	156.2	176.3	249.2	76.7
Currency	17.7	9.8	28.6	8.9	17.2	19.9	33.6	9.8
Equity	6.1	6.9	13.2	2.5	9.5	6.5	18.0	3.7
Commodity	9.6	0.4	18.1	0.3	14.3	8.9	31.9	6.3
Diversification		(55.3)				(81.5)		
	170.1	146.9	254.7	110.8	164.3	180.4	238.3	73.9

Key points

- The Group's period end VaR reduced as the exceptional volatility of the market data from the period of the financial crisis dropped out of the 500 days of time series data used in the VaR calculation. The credit spread VaR was particularly impacted as a result of this effect.
- Commodity VaR decreased during the year since a significant part of the Group's interest in Sempra Commodities JV was sold during the year.

Non-traded portfolios

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

In order to better represent the risk of the non-traded portfolios, the table below analyses the VaR for the non-trading portfolios but excludes Structured Credit Portfolio (SCP). These assets are shown separately on a drawn notional and fair value basis by maturity profile and asset class and are managed on both an asset and RWA basis.

Also excluded from the non-traded VaR are the loans and receivables products that are managed within the credit risk management framework. The 2009 and 2010 VaR data below is shown on this basis however, the VaR data for the 2008 period could not be recalculated excluding the SCP and LAR portfolios mentioned above due to data and system constraints.

The table below analyse's the risk for the Group's non-trading portfolios.

Non-trading VaR	2010				2009			
	Average £m	Period end £m	Maximum £m	Minimum £m	Average £m	Period end £m	Maximum £m	Minimum £m
Interest rate	8.0	6.1	19.1	4.5	12.7	12.0	27.5	7.6
Credit spread	32.5	13.3	101.2	12.1	81.7	99.9	134.4	39.7
Currency	2.1	1.9	6.1	0.3	1.2	0.5	3.9	0.2
Equity	—	—	0.7	—	—	—	0.1	—
Diversification		(5.2)				(18.5)		
	31.2	16.1	98.2	14.4	79.2	93.9	124.0	45.7

Key point

- The non-traded credit spread and total VaR have decreased significantly due to the implementation of the relative price-based mapping scheme in the VaR methodology discussed above and the sale of available-for-sale securities in the US mortgage business.

Risk management: Market risk *continued*
Structured Credit Portfolios

	Group					Group				
	Drawn notional					Fair value				
	CDOs £m	CLOs £m	MBS (1) £m	Other ABS £m	Total £m	CDOs £m	CLOs £m	MBS (1) £m	Other ABS £m	Total £m
2010										
1-2 years	—	—	—	47	47	—	—	—	42	42
2-3 years	85	19	44	98	246	81	18	37	91	227
3-4 years	—	41	20	205	266	—	37	19	191	247
4-5 years	16	—	—	—	16	15	—	—	—	15
5-10 years	98	466	311	437	1,312	87	422	220	384	1,113
>10 years	412	663	584	550	2,209	161	515	397	367	1,440
	611	1,189	959	1,337	4,096	344	992	673	1,075	3,084
2009										
1-2 years	—	—	—	81	81	—	—	—	68	68
2-3 years	40	—	—	19	59	24	—	—	18	42
3-4 years	19	18	42	99	178	16	17	31	76	140
4-5 years	17	47	36	332	432	3	41	29	275	348
5-10 years	107	685	424	521	1,737	90	594	251	394	1,329
>10 years	594	1,114	820	573	3,101	193	896	468	325	1,882
	777	1,864	1,322	1,625	5,588	326	1,548	779	1,156	3,809

Note:

(1) Mortgage-backed securities (MBS) include sub-prime residential mortgage-backed securities (RMBS) with a drawn notional amount of £471 million (2009 - £682 million) and a fair value of £329 million (2009 - £415 million), all with residual maturities of greater than 10 years.

The SCPs are within Non-Core. The risk on these portfolios is not measured or disclosed using VaR, as the Group believes this is not an appropriate tool for the banking book portfolio comprising of illiquid debt securities. The main driver of the reduction in drawn notional is the asset sales from a portfolio within an unwound securitisation arbitrage conduit. The impact of disposals on portfolio fair value has been partially offset by an increase in residual average price to 75% (2009 - 68%).

All disclosures in the following sections (pages 95 to 98) are unaudited and are marked with an asterisk (*).

Operational risk*

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. Operational risk is an integral and unavoidable part of the RBS Group's business as it is inherent in the processes it operates in to provide services to customers and generate profit for shareholders. An objective of operational risk management is not to remove operational risk altogether, but to manage the risk to an acceptable level, taking into account the cost of minimising the risk as against the resultant reduction in exposure. Strategies to manage operational risk include avoidance, transfer, acceptance and mitigation by controls.

Group Policy Framework (GPF)

The GPF supports a consistent approach to how we do business and helps everyone understand their individual and collective responsibilities. It is a core component of the RBS Group's Risk Appetite Framework; it supports the risk appetite setting process, and also underpins the control environment.

Work to design, implement and embed an enhanced GPF has continued throughout 2010 and will extend into 2011. The RBS Group's plans for ongoing development of GPF will support increased consistency in risk appetite setting across all risk types faced by the RBS Group, including alignment to the RBS Group's strategic business and risk objectives. The RBS Group will use relevant external reference points such as peers and rating agencies to challenge and verify the content of the Policy Standards making up GPF.

Three lines of defence model

To ensure appropriate responsibility is allocated for the management, reporting and escalation of operational risk, the RBS Group operates a three lines of defence model which outlines principles for the roles, responsibilities and accountabilities for operational risk management.

1st line of defence The business	2nd line of defence Operational risk	3rd line of defence Group Internal Audit
Accountable for the ownership and day-to-day management and control of operational risk.	Responsible for the implementation and maintenance of the operational risk framework, tools and methodologies.	Responsible for providing independent assurance on the design, adequacy and effectiveness of the RBS Group's system of internal controls.
Responsible for implementing processes in compliance with RBS Group policies.	Responsible for oversight and challenge on the adequacy of the risk and control processes operating in the business.	
Responsible for testing key controls and monitoring compliance with RBS Group policies.		

The RBS Group's Operational Risk Policy Standards (ORPS) are incorporated in the GPF. They provide the direction for delivering effective operational risk management and are designed to enable the consistent identification, assessment, management, monitoring and reporting of operational risk across the RBS Group.

The three lines of defence model and the ORPS apply throughout the RBS Group and are implemented taking into account the nature and scale of the underlying business. The following key operational risk management techniques are included in the ORPS;

Appropriate and effectively implemented Policy Standards are a fundamental component of GPF and support attainment and maintenance of an 'upper quartile' control framework as compared against our relevant peer set.

The GPF requires consideration and agreement through RBS Group governance of the level of risk appetite we have and how this is justifiable in the context of our strategic objectives.

There will be ongoing reassessment of risks, risk appetite and controls within the GPF and where appropriate, potential issues will be identified and addressed to ensure the RBS Group moves in line with the set objectives and remains constantly aligned with the 'upper quartile' objective and market practice at all times.

Through the three lines of defence model the RBS Group obtains assurance that the standards in the GPF are being adhered to. GPF defines requirements for testing and gathering evidence which demonstrates that each division and function is appropriately controlled.

GPF is owned and managed by the RBS Group's operational risk function and relies upon our operational risk framework for effective implementation and ongoing maintenance.

- *Risk and control assessments:* business units identify and assess operational risks to ensure that they are effectively managed, prioritised, documented and aligned to risk appetite;
- *Scenario analysis:* scenarios for operational risk are used to assess the possible impact of extreme but plausible operational risk loss events. Scenario assessments provide a forward looking basis for managing exposures that are beyond the RBS Group's risk appetite;

*unaudited

Risk management: Operational risk* *continued*

- **Loss data management:** each business unit's internal loss data management process captures all operational risk loss events above certain minimum thresholds. The data is used to enhance the adequacy and effectiveness of controls, identify opportunities to prevent or reduce the impact of recurrence, identify emerging themes, enable formal loss event reporting and inform risk and control assessments and scenario analysis. Escalation of individual events to senior management is determined by the seriousness of the event. Operational loss events are categorised under the following headings:
 - clients, products and business practices;
 - technology and infrastructure failures;
 - employment practices and workplace safety;
 - internal fraud;
 - external fraud;
 - execution, delivery and process management;
 - malicious damage; and
 - disaster and public safety.
- **New product approval process:** this process ensures that all new products or significant variations to existing products are subject to a comprehensive risk assessment. Products are evaluated and approved by specialist areas and are subject to executive approval prior to launch; and
- **Self certification process:** this requires management to monitor and report regularly on the internal control framework for which they are responsible, confirming its adequacy and effectiveness. This includes certifying compliance with the requirements of RBS Group policies.

Each business unit must manage its operational risk exposure within an acceptable level, testing the adequacy and effectiveness of controls and other risk mitigants (for example, insurance) regularly and documenting the results. Where unacceptable control weaknesses are identified, action plans must be produced and tracked to completion. The RBS Group purchases insurance to provide the business with financial protection against specific losses and to comply with statutory or contractual requirements. Insurance is used as a risk mitigation tool in controlling the RBS Group's exposures providing protection against financial loss once a risk has crystallised.

Operational risk metrics

Reporting forms an integral part of operational risk management. The RBS Group's risk management processes are designed to ensure that issues are identified, escalated and managed on a timely basis. Exposures for each division are reported through monthly risk and control reports, which provide details on the risk exposures and action plans. Events that have a material, actual or potential impact on the RBS Group's finances, reputation or customers, are escalated and reported to divisional and Group executive.

A high proportion of the RBS Group's operational risk events have a low financial cost associated with them and a very small proportion of operational risk events have a material impact.

*unaudited

Fraud prevention

Fraud remains a big challenge to the RBS Group, and the rest of the financial services industry. The RBS Group continues to respond to this threat, continually investing in people and processes for both detective and preventative measures, especially in relation to the impact of organised crime against the RBS Group. The RBS Group's key strategic programmes continue to focus on solutions for payment fraud, ATM security, identification of counterfeit documentation and online banking protection for the Group's customers. The Group's investments have resulted in multi-million pound savings and, through close working ties with law enforcement agencies, handing down of significant custodial sentences.

Physical security

The RBS Group continues to implement strong security measures to ensure the safety of staff, the RBS Group's customers and businesses from physical harm. Against an ever changing threat environment, these measures are kept under constant review and adapted accordingly. The past year has seen protests groups continue to target RBS (most notably Climate Camp in August 2010); robust processes are in place to ensure the safety of customers and staff during these demonstrations. The RBS Group also continues to mitigate against the threat posed by international related terrorism.

Information security

The RBS Group is committed to protecting customer, employee and Group information with regard to the loss of confidentiality, integrity and availability. This extends to all physical and electronic information. All employees and related third parties of the RBS Group are responsible for the protection of RBS Group assets, systems and information. All customer information is treated as confidential and appropriate security is applied to protect the information. Additionally, the RBS Group's information security policy is reviewed regularly and includes processes for managing and monitoring compliance with the policy. The same standards apply to information controlled by the RBS Group or managed by authorised third parties.

The RBS Group continues to invest in programmes to enhance and maintain information security controls and systems. For example, during 2010 the RBS Group have risk assessed the externally facing websites and penetration tested those websites that contain confidential, high-risk RBS Group data and established an assurance team to implement an ongoing programme of third party reviews.

Business continuity

The need to ensure the continuity of business across the RBS Group and the management of crisis situations is a key activity within the risk function. Key risks and threats that the RBS Group is consistently monitoring from a business continuity perspective include pandemics, terrorism, environmental impacts and technology disruptions. Business continuity plans are in place to ensure that the RBS Group can continue key products, services, and operations. A consistent crisis management framework has been developed that includes a six step methodology and allows incidents to be managed and resolved through skilled global teams.

All business continuity plans, related activities and systems are tested annually. The plan data is validated every 6 months and where the impact on business is high, the validation frequency is increased to every 3 months.

Regulatory risk*

Regulatory risk arises from the non-adherence to international and national rules and regulations. The RBS Group manages regulatory risk through a regulatory risk and compliance framework that seeks to ensure the RBS Group is in compliance with all banking, securities, insurance and anti-money laundering regulations defined by more than 120 different regulatory bodies and central banks across the world. This framework comprises global regulatory risk policies, tracking of regulatory developments, training and awareness, assurance and monitoring and regulatory relationship management.

Global regulatory risk policies

Within the Group Policy Framework (GPF), regulatory risk and compliance policies define minimum standards for all businesses to adhere to on a global basis. These policies are primarily driven by the rules and regulations set by the FSA as the RBS Group's lead regulator. These global minimum standards are supplemented by division specific policies where appropriate (product specific or local market specific requirements).

Regulatory developments

Regulatory environments are constantly evolving and it is critical that the RBS Group both understands early on the drivers for this change and be able to assess the potential impact of prospective rules and regulations on the different businesses. The regulatory developments tracker seeks to identify, track and monitor all such material changes and ensure that an appointed senior executive is responsible for assessing the potential impacts on the RBS Group's business. Such activity supports both effective engagement in the regulatory consultation process, and planning for the introduction of new or changed rules and regulations.

During the last 12 months the RBS Group has experienced unprecedented levels of prospective rules and regulations particularly in the area of prudential regulation (capital, liquidity, governance and risk management), and to the treatment of systemically important entities, in particular through initiatives on recovery and resolution plans ('living wills').

Training and awareness

Maintaining compliance with existing rules and regulations requires a continued investment in professional training and maintaining risk awareness. The RBS Group undertakes extensive training both with RBS Group wide learning initiatives (e.g. anti money laundering) as well as divisional or product specific training. To support the professional development of the RBS Group's regulatory risk staff the RBS Group has a comprehensive progressive training programme that is deployed on a global basis.

Assurance and monitoring

Assurance and monitoring activities are key to ensuring that the RBS Group can demonstrate on-going compliance with existing rules and regulations. Such activities are conducted in both the first line and second line of defence. Work to design, implement and embed enhanced monitoring tools was undertaken in 2010 and will continue into 2011.

Regulatory relationship management

The RBS Group is committed to working with its regulators in an open and constructive way as it deals with both the evolution of regulatory frameworks as well as the ongoing compliance to existing rules and regulations. The regulatory relationship management tool is used to track, record, monitor and report on all material regulatory engagement to ensure that activities remain co-ordinated across the RBS Group.

Reputation risk*

Reputation risk is defined as the potential loss in reputation that could lead to negative publicity, loss of revenue, costly litigation, a decline in the customer base or the exit of key RBS Group employees.

Reputation risk can arise from actions taken by the RBS Group or a failure to take action, such as failing to assess the environmental, social or ethical impacts of clients or projects that the RBS Group has provided products or services to.

The RBS Group seeks to safeguard its reputation by considering the impact on the value of its franchise from how it conducts business, its choice of customers and the way stakeholders view the RBS Group. Managing the Group's reputation is the joint responsibility of all employees, and reputational considerations should, as part of standard practice, be integrated into the RBS Group's day-to-day decision making structures.

Currently the RBS Group manages reputational risk through a number of functions, such as divisions, RBS Group Communications, RBS Group Sustainability and an Environmental, Social and Ethical (ESE) risk management function. The latter function is responsible for assessing ESE risks associated with business engagements and business divisions.

The Group Board has ultimate responsibility for managing any impact on the reputation of the RBS Group arising from its operations. The Group Sustainability Committee (established at the beginning of 2010) sets the overall strategy and approach for the management of RBS Group sustainability, however all parts of the RBS Group take responsibility for reputation management.

The risk is viewed as material given the central nature of the RBS Group's market reputation in the strategic risk objectives.

Risk management: Pension risk*

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

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

The trustee is solely responsible for the investment of the schemes assets which are held separately from the assets of the Group. The Group and the trustee must agree on the investment principles and the funding plan.

In October 2006, the Main scheme was closed to new employees. In November 2009, the RBS Group confirmed that it was making changes to the Main scheme and a number of other defined benefit schemes including the introduction of a limit of 2% per annum (or Consumer Price Indices (CPI) inflation, if lower) to the amount of any salary increase that will count for pensionable purposes.

Risk appetite and investment policy are agreed by the trustee with quantitative and qualitative input from the scheme actuaries and investment advisers. The trustee also consults with the RBS Group to obtain its view on the appropriate level of risk within the pension fund.

The RBS Group maintains an independent review of risk within its pension funds. The Group Risk Committee now monitors pension obligation risk on an ongoing basis with a monthly report illustrating the funding positions and key sensitivities of the RBS Group's pension schemes. Additionally, as part of the Internal Capital Adequacy Assessment Process (ICAAP) process, the change in asset and liability values is modelled over a twelve-month time horizon under a stressed scenario.

The funding valuation of the Main scheme at 31 March 2010 is currently in progress. Further details are given in Note 4 on the accounts.

The Main scheme, which represents 88% of plan assets at 31 December 2010, is invested in a diversified portfolio of quoted and private equity, government and corporate fixed interest and index-linked bonds, and other assets including property and hedge funds. The Trustee has taken measures to partially mitigate inflation and interest rate risks both by investment in suitable physical assets and by entering into inflation and interest rate swaps. The Main scheme has an additional exposure to rewarded risk by investing in equity futures.

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

	Change in value of assets £m	Change in value of liabilities £m	Decrease/ (increase) in net pension obligations £m
As at 31 December 2010			
Fall in nominal swap yields of 0.25% at all durations with no change in credit spreads	422	193	229
Fall in real swap yields of 0.25% at all durations with no change in credit spreads	355	799	(444)
Fall in credit spreads of 0.25% at all durations with no change in nominal or real swap yields	98	1,005	(907)
Fall in equity values of 10%	(1,083)	—	(1,083)

*unaudited

Other risk exposures

All the disclosures in this section (pages 99 to 114) are audited unless otherwise indicated with an asterisk (*).

Explanatory note

These disclosures provide information on certain elements of the Group's credit market activities, the majority of which reside in Non-Core and, to a lesser extent, Global Banking & Markets and US Retail & Commercial. For credit valuation adjustments (CVA), leveraged finance and conduits disclosures, the information presented has been analysed between the Group's Core and Non-Core businesses.

Definitions of acronyms used in this section are explained in the Glossary of terms on pages 255 to 260.

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 is detailed below.

	2010 £bn	2009 £bn	2008 £bn
Securities issued by central and local governments	97.8	101.3	65.7
Asset-backed securities	54.4	65.7	79.7
Securities issued by corporates and other entities	5.6	9.0	14.4
Securities issued by banks and building societies	8.2	9.2	18.0
	166.0	185.2	177.8

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

Debt securities include residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and other ABS. In many cases the risk associated with these assets is hedged by 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 tables summarise the gross and net exposures and carrying values of these securities by geography of the underlying assets at 31 December 2008, 2009 and 2010. Gross exposures represent the principal amounts relating to ABS. G10 government RMBS comprises securities that are: (a) guaranteed or effectively guaranteed by the US government, by way of its support for US federal agencies and government sponsored enterprises or (b) guaranteed by the Dutch government. Net exposures represent the carrying value after taking account of the hedge protection purchased from monoline insurers and other counterparties, but exclude the effect of counterparty credit valuation adjustments. The hedge provides credit protection of both principal and interest cash flows in the event of default by the counterparty. The value of this protection is based on the underlying instrument being protected.

Risk management: Other risk exposures *continued*
Asset-backed securities by geography and measurement classification

The tables below summarise ABS carrying values and net exposures by geography and measurement classification for the Group.

2010	US £m	UK £m	Other Europe £m	RoW (2) £m	FVTPL (1)				
					Total £m	HFT (3) £m	DFV (4) £m	AFS (5) £m	LAR (6) £m
Gross exposure									
RMBS: G10 government	24,206	16	—	—	24,222	13,839	—	10,383	—
RMBS: prime	1,773	3,039	1,096	192	6,100	1,606	1	4,446	47
RMBS: non-conforming	1,249	2,107	92	—	3,448	708	—	1,313	1,427
RMBS: sub-prime	792	362	139	221	1,514	818	—	497	199
CMBS	3,086	1,427	850	45	5,408	2,646	121	1,408	1,233
CDOs	12,152	128	313	—	12,593	7,943	1	4,550	99
CLOs	6,038	134	876	9	7,057	1,062	—	5,572	423
Other ABS	3,104	1,066	936	1,679	6,785	1,534	—	2,505	2,746
	52,400	8,279	4,302	2,146	67,127	30,156	123	30,674	6,174
Carrying value									
RMBS: G10 government	24,391	15	—	—	24,406	13,765	—	10,641	—
RMBS: prime	1,613	2,664	910	192	5,379	1,383	1	3,957	38
RMBS: non-conforming	1,084	1,959	92	—	3,135	605	—	1,102	1,428
RMBS: sub-prime	638	252	120	205	1,215	681	—	344	190
CMBS	2,937	1,314	581	38	4,870	2,263	117	1,282	1,208
CDOs	3,135	69	128	—	3,332	1,340	1	1,895	96
CLOs	5,333	102	632	3	6,070	691	—	4,958	421
Other ABS	2,780	865	729	1,641	6,015	1,260	—	2,117	2,638
	41,911	7,240	3,192	2,079	54,422	21,988	119	26,296	6,019
Net exposure									
RMBS: G10 government	24,391	15	—	—	24,406	13,765	—	10,641	—
RMBS: prime	1,513	2,613	576	191	4,893	897	1	3,957	38
RMBS: non-conforming	1,081	1,959	92	—	3,132	602	—	1,102	1,428
RMBS: sub-prime	289	249	112	176	826	304	—	332	190
CMBS	1,823	1,312	402	38	3,575	1,188	10	1,230	1,147
CDOs	1,085	39	119	—	1,243	742	1	404	96
CLOs	1,387	102	625	—	2,114	672	—	1,021	421
Other ABS	2,294	668	722	1,634	5,318	691	—	2,109	2,518
	33,863	6,957	2,648	2,039	45,507	18,861	12	20,796	5,838

For notes to this table refer to page 101.

Financial review

Risk and balance sheet management

2009	US £m	UK £m	Other Europe £m	RoW (2) £m	FVTPL (1)				
					Total £m	HFT (3) £m	DFV (4) £m	AFS (5) £m	LAR (6) £m
Carrying value									
RMBS: G10 government	26,985	15	—	—	27,000	13,363	—	13,637	—
RMBS: prime	2,689	3,847	1,459	209	8,204	2,449	1	5,259	495
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	205	1,639	1,271
CDOs	3,275	114	220	27	3,636	2,063	1	1,423	149
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
	47,743	8,545	6,389	2,978	65,655	26,246	207	31,640	7,562
Net exposure									
RMBS: G10 government	26,985	15	—	—	27,000	13,363	—	13,637	—
RMBS: prime	2,428	3,013	468	168	6,077	484	1	5,097	495
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	194	1,556	1,270
CDOs	743	72	203	26	1,044	521	1	373	149
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
	37,667	7,271	4,639	1,678	51,255	17,392	196	26,240	7,427
2008									
Carrying value									
RMBS: G10 government	33,458	26	—	—	33,484	18,586	—	14,898	—
RMBS: prime	5,623	4,084	2,725	241	12,673	3,788	1	8,400	484
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
	58,440	10,696	8,179	2,424	79,739	35,771	1	36,052	7,915
Net exposure									
RMBS: G10 government	33,458	26	—	—	33,484	18,586	—	14,898	—
RMBS: prime	5,548	2,998	1,784	210	10,540	1,656	1	8,399	484
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
	47,739	9,090	5,346	1,955	64,130	23,825	1	32,389	7,915

Notes:

- (1) Fair value through profit or loss.
- (2) Rest of the world.
- (3) Held-for-trading.
- (4) Designated as at fair value.
- (5) Available-for-sale.
- (6) Loans and receivables.

Financial review continued

Risk management: Other risk exposures continued

Asset-backed securities by geography and measurement classification continued

The table below summarises the rating levels of ABS carrying values of the Group. Credit ratings are based on those from rating agencies Standard & Poor's (S&P), Moody's and Fitch and have been mapped onto the S&P scale.

	AAA £m	AA to AA+ £m	A to AA- £m	BBB- to A- £m	Non- investment grade £m	Unrated £m	Total £m
2010							
RMBS: G10 government	24,406	—	—	—	—	—	24,406
RMBS: prime	4,012	142	52	79	900	194	5,379
RMBS: non-conforming	1,754	144	60	316	809	52	3,135
RMBS: sub-prime	313	116	212	39	458	77	1,215
CMBS	2,732	392	973	482	291	—	4,870
CDOs	444	567	186	187	1,863	85	3,332
CLOs	2,488	1,784	343	527	332	596	6,070
Other ABS	2,132	608	687	1,687	260	641	6,015
	38,281	3,753	2,513	3,317	4,913	1,645	54,422
2009							
RMBS: G10 government	27,000	—	—	—	—	—	27,000
RMBS: prime	5,941	659	501	544	558	1	8,204
RMBS: non-conforming	1,980	198	109	160	594	2	3,043
RMBS: sub-prime	545	121	306	87	579	153	1,791
CMBS	3,367	589	1,021	273	152	151	5,553
CDOs	437	943	254	943	797	262	3,636
CLOs	2,718	4,364	607	252	636	730	9,307
Other ABS	2,111	1,225	996	1,915	152	722	7,121
	44,099	8,099	3,794	4,174	3,468	2,021	65,655
2008							
RMBS: G10 government	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

Non-investment grade and unrated ABS

The table below summarises the carrying values by accounting classification of the Group's ABS rated as non-investment grade or those not publicly rated.

2010	Non-investment grade				Unrated			
	HFT £m	AFS £m	LAR £m	Total £m	HFT £m	AFS £m	LAR £m	Total £m
RMBS: prime	355	534	11	900	194	—	—	194
RMBS: non-conforming	388	415	6	809	52	—	—	52
RMBS: sub-prime	437	21	—	458	77	—	—	77
CMBS	198	17	76	291	—	—	—	—
CDOs	691	1,151	21	1,863	85	—	—	85
CLOs	239	5	88	332	267	329	—	596
Other ABS	147	13	100	260	192	104	345	641
	2,455	2,156	302	4,913	867	433	345	1,645
2009								
RMBS: prime	120	430	8	558	—	1	—	1
RMBS: non-conforming	253	341	—	594	—	2	—	2
RMBS: sub-prime	339	240	—	579	153	—	—	153
CMBS	100	3	49	152	150	—	1	151
CDOs	487	300	10	797	143	119	—	262
CLOs	269	359	8	636	207	523	—	730
Other ABS	78	63	11	152	253	134	335	722
	1,646	1,736	86	3,468	906	779	336	2,021
2008								
RMBS: G10 governments	—	—	—	—	9	—	—	9
RMBS: prime	59	47	—	106	2	—	—	2
RMBS: non-conforming	69	74	3	146	1	1	—	2
RMBS: sub-prime	625	124	—	749	—	—	—	—
CMBS	39	—	—	39	—	—	1	1
CDOs	1,151	92	—	1,243	173	—	66	239
CLOs	81	188	—	269	165	279	—	444
Other ABS	121	49	71	241	115	404	717	1,236
	2,145	574	74	2,793	465	684	784	1,933

Risk management: Other risk exposures *continued*

Residential mortgage-backed securities

RMBS are securities that represent an interest in a portfolio of residential mortgages. Repayments made on the underlying mortgages are used to make payments to holders of the RMBS. The risk of the RMBS will vary primarily depending on the quality and geographic region 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 with related vintages are set out below and described in the glossary on pages 255 to 260. The US market has more established definitions of differing underlying mortgage quality and these are used as the basis for the Group's RMBS categorisation.

The Group classifies RMBS as sub-prime or Alt-A based on industry standard criteria, including Fair Isaac Corporation scores (FICO), level of documentation and loan-to-value (LTV) ratios of the underlying mortgage loans. RMBS are classified as sub-prime if the mortgage portfolio comprises loans with FICO scores between 500 and 650 with full or limited documentation. Mortgages in Alt-A RMBS portfolios have FICO scores of 640 to 720, limited documentation and an original LTV of 70% to 95%. The FICO score is the determining factor in the classification of the Group's RMBS as sub-prime or Alt-A.

The table below analyses the vintage of the Group's carrying value of RMBS portfolios by geography and classification.

	By geography				Total £m	By classification			
	US £m	UK £m	Other Europe £m	RoW £m		G10 government £m	Prime £m	Non- conforming £m	Sub-prime £m
2010									
2004 and earlier	4,395	95	56	50	4,596	3,789	587	90	130
2005	2,579	123	173	28	2,903	1,527	580	568	228
2006	1,082	2,131	530	121	3,864	631	2,010	736	487
2007	2,434	2,065	154	33	4,686	1,811	1,167	1,476	232
2008	2,314	58	92	155	2,619	2,288	223	104	4
2009 and later	14,922	418	117	10	15,467	14,360	812	161	134
	27,726	4,890	1,122	397	34,135	24,406	5,379	3,135	1,215
2009									
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	1,788	2,424	452	50	4,714	1,064	1,708	1,529	413
2008 and later	15,249	9	138	249	15,645	14,714	509	215	207
	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

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 table below details the Group's CVA by type of counterparty.

	2010 £m	2009 £m	2008 £m
Monoline insurers	800	1,925	3,289
CDPCs	490	495	746
Other counterparties	1,609	1,401	1,089
	<u>2,899</u>	<u>3,821</u>	<u>5,124</u>

Monoline insurers

The Group has purchased protection from monoline insurers ("monolines") mainly against specific ABS. 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, however 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 market implied probability of defaults and internally assessed recovery levels to determine the level of expected loss on monoline exposures of different maturities. The probability of default is calculated with reference to market observable credit spreads and recovery levels. 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 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, all of which are in Non-Core.

	2010 £m	2009 £m	2008 £m
Gross exposure to monolines	1,781	3,582	6,531
Hedges with financial institutions	(71)	(512)	(518)
Credit valuation adjustment	(800)	(1,925)	(3,289)
Net exposure to monolines	<u>910</u>	<u>1,145</u>	<u>2,724</u>
Counterparty and credit risk RWAs*	£2.8bn	£13.1bn	
CVA as a % of gross exposure	45%	54%	50%

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

	2010 £m	2009 £m	2008 £m
Credit valuation adjustment at 1 January	(1,925)	(3,289)	(452)
Credit valuation adjustment at 31 December	(800)	(1,925)	(3,289)
Decrease/(increase) in credit valuation adjustment	1,125	1,364	(2,837)
Net (debit)/credit relating to realisations, hedges, foreign exchange and other movements	(702)	(1,478)	275
Net (debit)/credit relating to reclassified debt securities	(310)	(1,740)	741
Net credit/(debit) to income statement	<u>113</u>	<u>(1,854)</u>	<u>(1,821)</u>

* unaudited

Financial review continued

Risk management: Other risk exposures continued Monoline insurers continued

The table below summarises monoline exposures by rating for the Group. Credit ratings are based on those from ratings agencies S&P and Moody's. Where the ratings differ, the lower of the two is taken.

	Notional: protected assets £m	Fair value: reference protected assets £m	Gross exposure £m	Credit valuation adjustment £m	Hedges £m	Net exposure £m
2010						
A to AA-	5,890	5,110	780	254	—	526
Non-investment grade	3,375	2,374	1,001	546	71	384
	9,265	7,484	1,781	800	71	910
Of which:						
CMBS	712	524	188	131		
CDOs	292	56	236	106		
CLOs	5,661	5,075	586	193		
Other ABS	2,108	1,541	567	277		
Other	492	288	204	93		
	9,265	7,484	1,781	800		
2009						
A to AA-	6,560	5,355	1,205	361	—	844
Non-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:						
CMBS	719	328	391	247		
CDOs	1,454	624	830	566		
CLOs	8,844	7,435	1,409	628		
Other ABS	2,386	1,612	774	397		
Other	436	258	178	87		
	13,839	10,257	3,582	1,925		
2008						
AA to AA+	4,199	3,060	1,139	518	—	621
A to AA-	9,399	4,450	4,949	2,446	518	1,985
Non-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		
CMBS	662	321	341	194		
CLOs	8,092	5,999	2,093	1,060		
Other ABS	1,885	1,364	521	297		
Other	422	293	129	68		
	15,472	8,941	6,531	3,289		

Key points

- Exposure to monolines decreased over the period due to a combination of restructuring certain exposures and higher prices of underlying reference instruments, partially offset by the strengthening of the US dollar against sterling.
- The CVA decreased on a total basis, reflecting the reduction in exposure, but was stable on a relative basis with the impact of tighter credit spreads offset by an increase in the expected lives of certain trades.
- The reduction in the Group's RWA requirements over the quarter was driven by the reduction in exposure to monolines and the impact of restructuring certain risk structures.
- Regulatory intervention at certain monoline counterparties triggered International Swaps and Derivative Association (ISDA) credit events in the period. At the point of trigger the exposure to these counterparties was excluded from the RWA calculations and capital deductions of £171 million were taken instead. The impact of this together with restructuring certain exposures and an improvement in the rating of underlying reference bonds held by the Group to investment grade status were the main drivers of the reduction in RWA requirements during the second half of the year.*

The Group also has indirect exposures to monoline insurers through wrapped securities and other assets with credit enhancement from 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

A credit derivative product company (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 tranching and single name credit derivatives. The Group's exposure to CDPCs is predominantly due to tranching 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, the average attachment and detachment points are 13% and 49% respectively (2009 - 15% and 51% respectively; 2008 - 16% and 50% respectively), 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 with reference to recent market events impacting CDPCs, including communication activity, and by analysing the underlying trades and the cost of hedging expected default losses in excess of the capital in each vehicle.

A summary of the Group's exposure to CDPCs all of which are in Non-Core is detailed below.

	2010 £m	2009 £m	2008 £m
Gross exposure to CDPCs	1,244	1,264	2,638
Credit valuation adjustment	(490)	(495)	(746)
Net exposure to CDPCs	754	769	1,892
CVA as % of gross exposure	39%	39%	28%
Counterparty and credit risk RWAs*	£7.2bn	£7.5bn	£5.0bn
Capital deductions*	£280m	£347m	—

* unaudited

Risk management: Other risk exposures *continued*
Credit derivative product companies *continued*

The table below details the Group's CDPC exposures by rating.

	Notional: protected assets £m	Fair value: reference protected assets £m	Gross exposure £m	Credit valuation adjustment £m	Net exposure £m
2010					
AAA	213	212	1	—	1
A to AA-	644	629	15	4	11
Non-investment grade	20,066	19,050	1,016	401	615
Unrated	4,165	3,953	212	85	127
	25,088	23,844	1,244	490	754
2009					
AAA	1,658	1,637	21	5	16
BBB- to A-	1,070	1,043	27	9	18
Non-investment grade	17,080	16,137	943	373	570
Unrated	3,926	3,653	273	108	165
	23,734	22,470	1,264	495	769
2008					
AAA	959	549	410	82	328
AA to AA+	330	316	14	3	11
A to AA-	12,897	10,785	2,112	626	1,486
BBB- to A-	356	254	102	35	67
	14,542	11,904	2,638	746	1,892

The table below details the net income statement effect arising from the Group's CDPC exposures.

	2010 £m	2009 £m	2008 £m
Credit valuation adjustment at 1 January	(495)	(746)	—
Credit valuation adjustment at 31 December	(490)	(495)	(746)
Decrease/(increase) in credit valuation adjustment	5	251	(746)
Novations from RBS N.V.	4	449	621
Net debit relating to realisations, hedges, foreign exchange and other movements	(150)	(1,764)	(18)
Income from trading activities - net losses	(141)	(1,064)	(143)

Key points

- Losses reduced significantly in 2010 due to smaller exposures and reduced losses on hedges that were introduced to cap the exposures.
- The CVA decrease for the year reflected exposure reductions, due to trade commutations, tighter credit spreads of the underlying reference portfolios, partially offset by an increase in the relative value of senior tranches compared with the underlying reference portfolios and foreign currency movements.
- Counterparty and credit RWAs and capital deductions decreased in line with the exposure.
- Certain CDPCs, where the Group has hedges in place to cap the exposure, are excluded from the RWA calculations with capital deduction taken instead.

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 the 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. The majority 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.

The 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 for the Group is shown in the table below.

	2010 £m	2009 £m
Credit valuation adjustment at 1 January	(1,401)	(1,089)
Credit valuation adjustment at 31 December	(1,609)	(1,401)
Increase in credit valuation adjustment	(208)	(312)
Novations from RBS N.V.	—	90
Net credit/(debit) relating to realisations, hedges, foreign exchange and other movements	5	(390)
Income from trading activities - net losses	(203)	(612)

Key points

- The increase in CVA held against exposures to other counterparties was driven by rating downgrades of certain counterparties and the net impact of changes in credit spreads and counterparty exposures due to market moves. This increase was partially offset by a decrease due to the disposal of parts of the RBS Semptra Commodities JV business during the year.
- Gains on hedges and realised defaults are the primary drivers of the gain arising on foreign exchange, hedges, realisations and other movements.

Risk management: Other risk 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. Most of the leveraged finance loans held as part of the syndicated lending portfolio were reclassified from HFT to LAR in 2008.

The gross exposure represents the total amount of leveraged finance committed by the Group. 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.

The table below shows the Groups global markets sponsor-led leveraged finance exposures, all of which are in Non-Core, by industry and geography.

	2010					2009					2008 Total £m
	UK £m	Americas £m	Other Europe £m	RoW £m	Total £m	UK £m	Americas £m	Other Europe £m	RoW £m	Total £m	
Gross exposure											
TMT (1)	1,451	513	485	238	2,687	1,656	1,591	775	302	4,324	5,725
Industrial	966	273	682	116	2,037	1,475	593	1,190	96	3,354	3,545
Retail	290	8	525	51	874	476	17	705	59	1,257	2,429
Other	1,074	163	432	145	1,814	1,527	216	866	184	2,793	2,933
	3,781	957	2,124	550	7,412	5,134	2,417	3,536	641	11,728	14,632
Net exposure											
TMT (1)	1,267	481	483	230	2,461	1,532	1,311	771	295	3,909	5,348
Industrial	868	181	656	115	1,820	925	520	1,161	95	2,701	3,091
Retail	277	8	474	47	806	445	17	634	56	1,152	2,061
Other	1,013	163	426	145	1,747	1,461	216	846	184	2,707	2,844
	3,425	833	2,039	537	6,834	4,363	2,064	3,412	630	10,469	13,344
Of which:											
Drawn	2,915	490	1,542	486	5,433	3,698	1,722	2,640	541	8,601	10,752
Undrawn	510	343	497	51	1,401	665	342	772	89	1,868	2,592
	3,425	833	2,039	537	6,834	4,363	2,064	3,412	630	10,469	13,344

Notes:

(1) Telecommunications, media and technology.

(2) All of the above exposures are classified as LAR, except £154 million (2009 - £143 million; 2008 - £102 million), which are classified as HFT.

The table below analyses the Group's movement in leveraged finance exposures for the year.

	2010			2009		
	Drawn £m	Undrawn £m	Total £m	Drawn £m	Undrawn £m	Total £m
Balance at 1 January	8,601	1,868	10,469	10,752	2,592	13,344
Transfers (out)/in	(120)	(22)	(142)	506	41	547
Sales and restructuring	(2,806)	(273)	(3,079)	(245)	(145)	(390)
Repayments and facility reductions	(434)	(71)	(505)	(900)	(381)	(1,281)
Funded deals	96	(96)	—	115	(115)	—
Changes in fair value	70	—	70	(31)	—	(31)
Accretion of interest	50	—	50	100	—	100
Impairment provisions	(19)	—	(19)	(1,121)	—	(1,121)
Exchange and other movements	(5)	(5)	(10)	(575)	(124)	(699)
Balance at 31 December	5,433	1,401	6,834	8,601	1,868	10,469

Key points

- Reduction in exposures reflect the Non-Core strategy.
- Approximately 90% of the above exposures represent senior lending at 31 December 2010.

In addition to the above, UK Corporate and Ulster Bank have leveraged finance exposures as set out below.

	2010 £m	2009 £m	2008 £m
UK Corporate			
- debt financing (1)	3,664	4,041	4,496
- senior debt transactions (2)	2,604	3,034	2,330
Total UK Corporate	6,268	7,075	6,826
Ulster Bank	597	621	694
	6,865	7,696	7,520

Notes:

- (1) Loans for UK mid-market buyouts, supplementing equity capital provided by third party private equity investors.
(2) Loans to UK mid-corporates supporting acquisitions, recapitalisations or general corporate purposes where higher leverage criteria were met.

Special purpose entities

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.

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 primarily as a way of diversifying funding sources. 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 contributed to the Group's sources of funding in the face of the contraction in the UK market for inter-bank lending, particularly during 2008 and 2009, and investor base for securitisations.

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.

	2010		2009		2008	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Residential mortgages	75,847	17,881	68,963	15,749	53,528	18,613
Credit card receivables	3,993	34	2,975	1,592	3,004	3,197
Other loans	30,988	974	36,448	1,010	1,679	1,071
Finance lease receivables	510	510	597	597	1,077	857

Risk management: Other risk exposures *continued*

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. 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.

During the year both multi-seller and own asset conduit assets have been reduced in line with wider Group balance sheet management. The total assets held by Group-sponsored conduits were £17.8 billion at 31 December 2010 (2009 - £19.7 billion; 2008 - £31.5 billion).

	2010			2009 Total £m	2008 Total £m
	Core £m	Non-Core £m	Total £m		
Total assets held by the conduits	14,142	3,624	17,766	19,671	31,473
Commercial paper issued (1)	13,277	2,540	15,817	17,888	30,833
Liquidity and credit enhancements:					
Deal specific liquidity:					
- drawn	868	1,109	1,977	1,797	640
- undrawn	19,642	2,980	22,622	24,631	38,201
PWCE (2)	1,025	257	1,282	1,508	2,072
	21,535	4,346	25,881	27,936	40,913
Maximum exposure to loss (3)	20,510	4,089	24,599	26,428	38,841

Notes:

(1) Includes £0.7 billion of ABCP issued to RBS plc, the Bank as at 31 December 2010.

(2) Programme-wide credit enhancements.

(3) 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.

Information relating to assets in the conduits is set out on pages 113 and 114.

Multi-seller conduits accounted for 46% of the total liquidity and credit enhancements committed by the Group at 31 December 2010 (2009 - 50%; 2008 - 100%). The Group's multi-seller conduits have continued to fund the vast majority of their assets solely through asset-backed commercial paper (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.

The Group holds two own-asset conduits, which have assets that were previously funded by the Group. The Group's maximum exposure to loss on these two conduits was £1.8 billion at 31 December 2010 (2009 - £1.2 billion; 2008 - nil), with nil ABCP outstanding at that date (2009 and 2008 - nil).

Additionally the Group established an own-asset conduit in 2009 with a committed liquidity of £26.0 billion (2009 - £25.1 billion) to access the Bank of England's open market operations for contingent funding purposes.

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 rewards. The Group's exposure from third-party conduits was £36 million (2009 - £487 million; 2008 - £3.3 billion) representing deal specific liquidity.

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

2010	Funded assets			Undrawn £m	Liquidity for third parties £m	Total exposure £m
	Loans £m	Securities £m	Total £m			
Auto loans	4,943	346	5,289	2,964	—	8,253
Corporate loans	115	92	207	61	—	268
Credit card receivables	2,088	—	2,088	1,209	—	3,297
Trade receivables	761	—	761	1,090	—	1,851
Student loans	757	—	757	532	(132)	1,157
Consumer loans	1,889	—	1,889	111	—	2,000
Mortgages						
- prime	2,569	3	2,572	752	—	3,324
- non-conforming	1,371	—	1,371	20	—	1,391
- sub-prime residential mortgages	103	—	103	19	—	122
- commercial	210	450	660	76	(21)	715
Other	1,072	997	2,069	(8)	(10)	2,051
	15,878	1,888	17,766	6,826	(163)	24,429
<hr/>						
2009						
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
<hr/>						
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

Risk management: Other risk exposures *continued*
Conduits *continued*

	Geographic distribution					Weighted average life-years	CP funded assets					Below BBB £m
	UK £m	Other Europe £m	US £m	RoW £m	Total £m		AAA £m	AA £m	A £m	BBB £m		
2010												
Auto loans	429	962	3,434	464	5,289	1.6	4,827	354	101	7	—	—
Corporate loans	—	192	15	—	207	8.0	26	53	128	—	—	—
Credit card receivables	144	—	1,944	—	2,088	1.4	1,912	125	—	51	—	—
Trade receivables	—	261	500	—	761	1.1	265	353	95	48	—	—
Student loans	116	—	641	—	757	1.9	641	116	—	—	—	—
Consumer loans	766	462	661	—	1,889	2.5	16	—	1,873	—	—	—
Mortgages												
- prime	161	—	—	2,411	2,572	2.7	1,043	1,476	32	21	—	—
- sub-prime	103	—	—	—	103	2.3	—	68	—	35	—	—
- non-conforming	712	659	—	—	1,371	4.8	782	273	316	—	—	—
- commercial	627	—	—	33	660	11.8	16	5	635	4	—	—
Other	447	455	353	814	2,069	1.7	95	52	1,242	680	—	—
	3,505	2,991	7,548	3,722	17,766	2.5	9,623	2,875	4,422	846	—	—
2009												
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	—	—	—
Corporate loans	320	110	—	—	430	1.7	—	—	430	—	—	—
Credit card receivables	633	—	4,999	—	5,632	0.7	3,465	62	1,959	146	—	—
Trade receivables	68	922	1,371	345	2,706	0.8	120	1,025	1,561	—	—	—
Student loans	144	—	2,411	—	2,555	0.3	2,296	144	115	—	—	—
Consumer loans	708	1,195	468	—	2,371	1.7	387	993	923	68	—	—
Mortgages												
- prime	—	—	—	1,822	1,822	3.7	17	1,806	—	—	—	—
- non-conforming	960	1,221	—	—	2,181	4.6	351	368	475	987	—	—
- commercial	713	453	74	336	1,576	12.1	274	518	315	469	—	—
Other	166	1,198	684	99	2,147	2.1	3	601	1,309	233	—	—
	4,513	6,805	17,409	2,746	31,473	2.0	12,988	6,385	10,197	1,903	—	—

Asset Protection Scheme*

All the disclosures in this section (pages 115 to 119) 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 at 31 December 2008, of which £48.8 billion of assets held by RBS N.V., 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 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 produced by the APS, the RBS Group paid an initial premium of £1.4 billion on 31 December 2009. A further premium of £700 million was paid on 31 December 2010. Quarterly premiums of £125 million are payable from 31 December 2011 and subsequently until the earlier of 31 December 2099 or the termination of the agreement.

Losses are recognised when a covered asset has experienced a trigger event which comprises of failure to pay (subject to grace periods) bankruptcy and restructuring.

APS assets are spread across the Group's main divisions. High volume commercial and retail exposures were selected on a portfolio basis where assets were high risk and in arrears at 31 December 2008. Large corporate and GBM exposures were selected at the counterparty/asset level based on high individual risk reviews and defaulted assets in the workout/restructuring unit.

HMT has the right to appoint step-in managers to carry out any oversight, management or additional functions on behalf of HMT to ensure that the covered assets are managed and administered in compliance with the agreed terms and conditions. This right is exercisable if certain step-in triggers occur. These include:

- losses on covered assets in total exceed 125% of the first loss amount or losses on an individual covered asset class exceed specified thresholds;
- a breach of specified obligations in the APS rules or the accession agreement;
- the Group has failed or is failing to comply with any of the conditions in the APS rules in relation to asset management, monitoring and reporting, and governance and oversight and such failure is persistent and material or it is evidence of a systematic problem; and
- material or systematic data deficiencies in the information provided to HMT in accordance with the terms of APS.

HMT may at any time elect to cease to exercise its step-in rights in whole or part when it is satisfied that the step-in triggers have been remedied.

The Bank has also entered into two agreements with RBS N.V. under which it has sold credit protection over the exposures held by RBS N.V. 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.

* unaudited

Risk management: Asset Protection Scheme* continued

Covered assets: Roll forward to 31 December 2010

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

	Group £bn	RBS N.V. £bn	RBS Group £bn
Covered assets at 1 January 2010 ⁽¹⁾	203.3	27.2	230.5
Disposals	(8.8)	(0.9)	(9.7)
Maturities, amortisation and early repayments	(20.1)	(8.6)	(28.7)
Intra-RBS Group transfers	0.8	(0.8)	—
Reclassified assets ⁽²⁾	5.0	(1.9)	3.1
Withdrawals	(2.8)	(0.1)	(2.9)
Effect of foreign currency movements and other adjustments	(0.1)	2.5	2.4
Covered assets at 31 December 2010	<u>177.3</u>	<u>17.4</u>	<u>194.7</u>

Notes:

(1) The Asset Protection Agency (APA) and the RBS Group have now reached agreement on substantially all eligibility issues.

(2) In Q2 2010, the APA and the Group reached agreement over the classification of some structured credit assets which resulted in adjustments to the covered amount, without affecting the underlying risk protection.

Key points

- The reduction in covered assets was due to run-off of the portfolio, disposals, early repayments and maturing loans.
- As part of the RBS Group's risk reduction strategy significant disposals were made from the Structured Credit Portfolio (2010 - £3.0 billion). The RBS Group took advantage of market conditions and executed sales from its derivative, loan and leveraged finance portfolios (2010 - £6.7 billion).

* unaudited

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:

	2010			2009			2008		
	Group £m	RBS N.V. £m	RBS Group £m	Group £m	RBS N.V. £m	RBS Group £m	Group £m	RBS N.V. £m	RBS Group £m
Loans and advances	15,904	2,129	18,033	11,857	2,383	14,240	6,192	1,513	7,705
Debt securities	11,571	176	11,747	7,512	304	7,816	5,562	2,380	7,942
Derivatives	1,008	1,035	2,043	4,908	1,926	6,834	3,972	2,603	6,575
	28,483	3,340	31,823	24,277	4,613	28,890	15,726	6,496	22,222
By division:									
UK Retail	2,964	—	2,964	2,431	—	2,431	1,492	—	1,492
UK Corporate	1,382	—	1,382	1,007	—	1,007	285	—	285
Ulster Bank	804	—	804	486	—	486	234	—	234
Retail & Commercial	5,150	—	5,150	3,924	—	3,924	2,011	—	2,011
Global Banking & Markets	1,107	389	1,496	1,292	336	1,628	1,549	91	1,640
Core	6,257	389	6,646	5,216	336	5,552	3,560	91	3,651
Non-Core	22,226	2,951	25,177	19,061	4,277	23,338	12,166	6,405	18,571
	28,483	3,340	31,823	24,277	4,613	28,890	15,726	6,496	22,222

Key points

- The increase in Non-Core impairments of £1.8 billion accounted for the majority of the increase in credit impairments and write-downs in 2010.
- The reduction in GBM is largely a result of transfers to Non-Core in the second half of the year.
- The APA and the RBS Group reached agreement for the purposes of the Scheme, on the classification of some structured credit assets which has resulted in adjustments to credit impairments and write downs mainly between debt securities and derivatives.

Risk management: Asset Protection Scheme* *continued*
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. As with any bespoke and highly complex legal agreement there are various areas of interpretation, some of which could have a material impact on the net triggered amount identified to date.

The Scheme rules are designed to allow for data correction over the life of the Scheme.

The table below summarises the total triggered amount and related cash recoveries by division at 31 December 2010.

	Group			RBS N.V.			RBS Group		
	Triggered amount £m	Cash recoveries to date £m	Net triggered amount £m	Triggered amount £m	Cash recoveries to date £m	Net triggered amount £m	Triggered amount £m	Cash recoveries to date £m	Net triggered amount £m
UK Retail	3,675	455	3,220	—	—	—	3,675	455	3,220
UK Corporate	4,640	1,115	3,525	—	—	—	4,640	1,115	3,525
Ulster Bank	1,500	160	1,340	—	—	—	1,500	160	1,340
Retail & Commercial	9,815	1,730	8,085	—	—	—	9,815	1,730	8,085
Global Banking & Markets	1,635	259	1,376	912	490	422	2,547	749	1,798
Core	11,450	1,989	9,461	912	490	422	12,362	2,479	9,883
Non-Core	28,901	3,475	25,426	3,237	1,069	2,168	32,138	4,544	27,594
	<u>40,351</u>	<u>5,464</u>	<u>34,887</u>	<u>4,149</u>	<u>1,559</u>	<u>2,590</u>	<u>44,500</u>	<u>7,023</u>	<u>37,477</u>
Loss credits			<u>1,241</u>			<u>—</u>			<u>1,241</u>
			<u>36,128</u>			<u>2,590</u>			<u>38,718</u>

Notes:

- (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 or restructuring with an impairment) and is the lower of the covered amount and the outstanding amount for each covered asset. The RBS Group expects additional assets to trigger upon expiry of relevant grace periods based on the current risk rating and level of impairments on covered assets.
- (2) Following the reclassification of some structured credit assets from derivatives to debt securities, the APA and the RBS Group also reached agreement on an additional implied write down trigger in respect of these assets. This occurs if (a) on two successive relevant payment dates, the covered asset has a rating of Caa2 or below by Moody's, CCC or below by Standard & Poor's or Fitch or a comparable rating from an internationally recognised credit rating agency and/or (b) on any two successive relevant payment dates, the mark-to-market value of the covered asset is equal to or less than 40 per cent of the par value of the covered asset, in each case as at such relevant payment date.
- (3) Under the Scheme rules, the RBS Group may apply to the APA for loss credits in respect of the disposal of non-triggered assets. A loss credit counts towards the first loss threshold and is typically determined by the APA based on the expected loss of the relevant asset.
- (4) The RBS Group and the APA remain in discussion with regard to loss credits in relation to the withdrawal of £2.0 billion of derivative assets during Q2 2010 and the disposal of approximately £1.6 billion of structured finance and leveraged finance assets in 2010.
- (5) The Scheme rules contain provision for on-going revision of data.

Key points

- The RBS Group received loss credits in relation to some of the withdrawals and disposals of £1.2 billion in 2010.
- The RBS Group currently expects recoveries on triggered amounts to be approximately 45% over the life of the relevant assets. On this basis, the expected loss on triggered assets at 31 December 2010 is approximately £25 billion (42%) of the £60 billion first loss threshold under APS.

* unaudited

Risk-weighted assets

The table below analyses the Group's risk-weighted assets (RWAs) by division, covered by APS.

	2010 £bn	2009 £bn
UK Retail	12.4	16.3
UK Corporate	22.9	31.0
Ulster Bank	7.9	8.9
Retail & Commercial	43.2	56.2
Global Banking & Markets	11.5	19.9
Core	54.7	76.1
Non-Core	50.9	51.5
APS RWAs	105.6	127.6
of which: RBS N.V.	15.8	11.2

Key points

- The decrease of £22 billion in RWAs reflects disposals and early repayments as well as changes in risk parameters.
- The increase in APS RWAs for RBS N.V. primarily reflected its migration to Basel II regime.
- In Non-Core, disposals and early repayments were offset by changes in risk parameters.

Report of the directors

The directors present their report together with the audited accounts for the year ended 31 December 2010.

Group structure

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 17 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 RBS Group's website, www.rbs.com

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

During 2010, the holding company converted certain non-cumulative convertible preference shares into ordinary shares in the holding company. As a result, HMT's holding in the holding company's ordinary shares reduced to 67.8%.

Business review

Activities

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, are contained in the Financial review on pages 3 and 4.

Asset Protection Scheme

On 22 December 2009, The Royal Bank of Scotland plc entered into an agreement, the Asset Protection Scheme (APS), with HMT acting on behalf of the UK Government, under which it purchased credit protection over a portfolio of specified assets and exposures (covered assets) from HMT. The APS provides additional protection to the RBS Group's capital ratios 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. Certain risk factors the Group faces are summarised on page 5. Fuller details of these and other risk factors are set out on pages 238 to 254.

The reported results of the Group are also 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 judgments are included in Accounting policies on pages 132 to 141.

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 and balance sheet management section of the Financial review on pages 21 to 119.

Financial performance

A review of the Group's performance during the year ended 31 December 2010, including details of each division, and the Group's financial position as at that date is contained in the Financial review on pages 6 to 20.

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 2010, the Bank and its subsidiaries employed over 113,600 employees (full time equivalent basis), throughout the world. Details of employee related costs are included in Note 3 on the accounts on page 144.

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, learning networks and targeted leadership programmes. Employees are also encouraged to do voluntary work with community partners.

Employee communication

Employee engagement is encouraged through a range of communication channels, at both divisional and RBS 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 RBS Group executives regularly communicate with and encourage feedback from 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 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 2010 survey took place in September 2010 and the final response rate was 81%. This represents over 119,000 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 fora 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 recognises that the diversity of its workforce is a significant and necessary asset to the business. During 2010, the RBS Group executive renewed its commitment to ensuring a working environment that is inclusive to all and one that will enable all employees to develop to their full potential.

The RBS Group 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 RBS Group including support of external charitable networks and for and as part of the community engagement and supplier relationships. Internally, the Group supports initiatives such as the Women in Business network.

Safety, health and wellbeing

Ensuring the safety, health and wellbeing of employees and customers is core to the RBS Group's business, and a fundamental social responsibility for the RBS Group.

During 2010, the RBS Group continued to focus on compliance, governance and managing risk across all jurisdictions. Enhanced services and supporting communication 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.

Sustainability

Sustainability is central to the way the RBS Group is managed. Sustainability is not just about the many responsibilities and obligations that the RBS Group has in a legal sense, but about specific issues that need to be addressed to ensure that RBS Group is a healthy and respected business operating on a sustainable basis. There is a clear governance structure for RBS Group Sustainability that oversees and aligns the RBS Group's approach to the range of social, ethical and environmental issues which confront the business on a daily basis.

The Group continues to do significant work and address challenges across five key themes: Fair banking, Supporting enterprise, Employee engagement, Safety and security and Citizenship and environmental sustainability.

Further details of the RBS Group's Sustainability policies are available on www.rbs.com/sustainability and in the Annual 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 21 to 119 of the Financial review. The risk factors which could materially affect the Group's future results are set out on pages 238 to 254.

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.

Corporate governance

Internal control over financial reporting

The internal controls over financial reporting for the Group are consistent with those at the RBS Group level. The RBS Group is required to comply with Section 404 of the US Sarbanes-Oxley Act of 2002 and assess the effectiveness of internal control over financial reporting as of 31 December 2010.

The RBS Group assessed the effectiveness of its internal control over financial reporting as of 31 December 2010 based on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in 'Internal Control - Integrated Framework'.

Based on its assessment, management has concluded that, as of 31 December 2010, the RBS Group's internal control over financial reporting is effective.

The RBS Group's auditors have audited the effectiveness of RBS Group's internal control over financial reporting and have given an unqualified opinion.

Management's report on the RBS Group's internal control over financial reporting will be filed with the Securities and Exchange Commission at the same time as the Annual Report on Form 20-F.

Board of directors

The Board is the main decision-making forum for the Bank. It has overall responsibility for management of the business and affairs of the Group, the establishment of Group strategy and the allocation and raising of capital, and is accountable to shareholders for financial and operational performance. The Board considers strategic issues and ensures the Group manages risk effectively through approving and monitoring the Group's risk appetite, considering Group stress scenarios and agreed mitigants and identifying longer term strategic threats to the Group's business operations. The Board has a formal schedule of matters detailing key aspects of the Bank's affairs reserved to it for its decision. This schedule is reviewed bi-annually.

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

The Audit Committee is comprised of at least three independent non-executive directors. It is responsible for assisting the Board in discharging its responsibilities in relation to the disclosure of the financial affairs of the Group. The Audit Committee reviews the accounting policies, financial reporting and regulatory compliance practices of the Group, the Group's system and standards of internal controls, monitors the Group's processes for internal audit and external audit and reviews the practices of the Divisional Risk and Audit Committees.

The Board Risk Committee is comprised of at least three independent non-executive directors. It is responsible for providing oversight and advice to the Board in relation to current and potential future risk exposures of the Group and future risk strategy, including determination of risk appetite and tolerance.

The Remuneration Committee is comprised of at least three independent non-executive directors. It is responsible for the overview of the Group's remuneration policy and remuneration governance framework, ensuring that remuneration arrangements are consistent with and promote effective risk management. The committee also makes recommendations to the Board in respect of remuneration arrangements for executive directors.

The Nominations Committee comprises all of the non-executive directors, and is chaired by the Chairman of the Group. It is responsible for assisting the Board in the formal selection and appointment of directors, having regard to the overall balance of skills, knowledge, experience and diversity on the Board as well as considering succession planning and reviewing the structure, size and composition of the Board, Audit Committee, Board Risk Committee and Remuneration Committee.

The Group Sustainability Committee is chaired by the Senior Independent Director and is attended by the Chairman and members of the Group executive and senior management. It reports to the Board and is responsible for reviewing the Group's overall sustainability strategy, values and policies.

The Executive Committee provides executive input to the Group Board, and monitors and reports to the Group Board on all operational and day to day activities in relation to the Group's businesses.

The Management Committee, comprising the Group's major business and functional leaders, meets three to four times annually as a vehicle for strategy and business performance review.

Share capital

Details of the ordinary and preference share capital at 31 December 2010 are shown in Note 27 on the accounts.

Directors

The current members of the Board of directors are shown on page 2.

Colin Buchan, Sandy Crombie, Philip Hampton, Stephen Hester, Penny Hughes, Joe MacHale, John McFarlane, Art Ryan, Philip Scott and Bruce Van Saun all served throughout the year and to the date of signing the financial statements.

Gordon Pell retired as an executive director on 31 March 2010.

Brendan Nelson was appointed as a non-executive director on 1 April 2010.

Archie Hunter retired as a non-executive director on 28 April 2010.

All directors of the Bank will stand for re-election at the forthcoming Annual General Meeting and annually thereafter. Colin Buchan will stand down as a non-executive director on 5 August 2011 following the announcement of the RBS Group's interim results, having served just over nine years on the Board.

Group General Counsel and Group Secretary

Miller McLean retired as Group General Counsel and Group Secretary on 30 April 2010. He was succeeded by Chris Campbell as Group General Counsel and Aileen Taylor as Group Secretary.

Directors' interests

The interests of the directors in the shares of the holding company at 31 December 2010 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 2010 to 30 March 2011.

Directors' indemnities

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

In terms of section 236 of the Companies Act, Qualifying Pension Scheme Indemnity Provisions have been issued to all trustees of the RBS Group's pension schemes during 2010.

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 2010 was £25.2 million (2009 - £34.6 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 2010, the Group's trade creditors represented 29 days (2009 - 30 days) of amounts invoiced by suppliers.

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.

Auditors

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

By order of the Board

Aileen Taylor
Secretary
30 March 2011

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

Aileen Taylor
Secretary
30 March 2011

We, the directors listed below, 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

30 March 2011

Board of directors

Chairman
Philip Hampton

Executive directors
Stephen Hester
Bruce Van Saun

Non-executive directors
Colin Buchan
Sandy Crombie
Penny Hughes
Joe MacHale
John McFarlane
Brendan Nelson
Arthur 'Art' Ryan
Philip Scott

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 2010 which comprise the accounting policies, the balance sheets as at 31 December 2010, 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 2010, the related Notes 1 to 42 and the information identified as 'audited' in the Risk and balance sheet 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 and, as regards the Bank financial statements, 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 auditor's 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 auditor

As explained more fully in the statement of directors' responsibilities 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 and express an opinion on 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 2010 and of the Group's loss for the year then ended;
- the Group's financial statements have been properly prepared in accordance with IFRS as adopted by the European Union;
- the Bank's financial statements have been properly prepared in accordance with IFRS as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; 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 Report of the directors 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 matters where the Companies Act 2006 requires us 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.

Kari Hale (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London, United Kingdom
30 March 2011

Consolidated income statement

for the year ended 31 December 2010

	Note	2010 £m	2009 £m	2008 £m
Interest receivable		19,417	21,160	31,413
Interest payable		(7,306)	(9,617)	(17,904)
Net interest income	1	12,111	11,543	13,509
Fees and commissions receivable	2	7,591	7,734	7,483
Fees and commissions payable	2	(2,060)	(1,972)	(1,733)
Income/(loss) from trading activities	2	3,361	3,007	(5,583)
Gain on redemption of own debt	2	502	2,694	—
Other operating income	2	2,199	1,537	2,181
Non-interest income		11,593	13,000	2,348
Total income		23,704	24,543	15,857
Staff costs				
- excluding curtailment gains		(7,880)	(7,738)	(6,142)
- pension schemes curtailment gains		—	2,148	—
Premises and equipment		(1,909)	(1,983)	(1,760)
Other administrative expenses		(2,996)	(3,094)	(2,759)
Depreciation and amortisation		(1,689)	(1,587)	(1,562)
Write-down of goodwill and other intangible assets		(1)	(118)	(8,144)
Operating expenses	3	(14,475)	(12,372)	(20,367)
Profit/(loss) before impairment losses		9,229	12,171	(4,510)
Impairment losses	13	(9,400)	(12,174)	(4,706)
Operating loss before tax		(171)	(3)	(9,216)
Tax (charge)/credit	6	(713)	523	505
(Loss)/profit for the year		(884)	520	(8,711)
(Loss)/profit attributable to:				
Non-controlling interests	26	29	235	208
Preference shareholders	7	60	523	638
Ordinary shareholders		(973)	(238)	(9,557)
		(884)	520	(8,711)

The accompanying notes on pages 142 to 235, the accounting policies on pages 132 to 141 and the audited sections of the 'Financial review: Risk and balance sheet management' on pages 21 to 119 form an integral part of these financial statements.

Consolidated statement of comprehensive income

for the year ended 31 December 2010

Financial statements

	Note	2010 £m	2009 £m	2008 £m
(Loss)/profit for the year		(884)	520	(8,711)
Other comprehensive income/(loss)				
Available-for-sale financial assets		1,506	2,434	(2,596)
Cash flow hedges		114	850	(276)
Currency translation		331	(1,584)	4,968
Actuarial gains/(losses) on defined benefit plans	4	176	(3,676)	(1,716)
Other comprehensive income/(loss) before tax		2,127	(1,976)	380
Tax (charge)/credit		(519)	30	1,627
Other comprehensive income/(loss) after tax		1,608	(1,946)	2,007
Total comprehensive income/(loss) for the year		<u>724</u>	<u>(1,426)</u>	<u>(6,704)</u>
Total comprehensive income/(loss) recognised in the statement of changes in equity is attributable as follows:				
Non-controlling interests		96	109	552
Preference shareholders		60	523	638
Ordinary shareholders		568	(2,058)	(7,894)
		<u>724</u>	<u>(1,426)</u>	<u>(6,704)</u>

The accompanying notes on pages 142 to 235, the accounting policies on pages 132 to 141 and the audited sections of the 'Financial review: Risk and balance sheet management' on pages 21 to 119 form an integral part of these financial statements.

Balance sheets

as at 31 December 2010

	Note	Group			Bank		
		2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Assets							
Cash and balances at central banks	10	49,838	27,060	6,806	44,921	21,099	3,714
Loans and advances to banks	10	87,505	68,441	79,387	100,965	77,365	91,717
Loans and advances to customers	10	518,321	536,169	619,503	349,179	338,548	327,040
Debt securities subject to repurchase agreements	29	79,558	65,589	75,660	41,203	30,070	70,206
Other debt securities		86,471	119,592	102,106	148,005	184,528	89,492
Debt securities	15	166,029	185,181	177,766	189,208	214,598	159,698
Equity shares	16	2,340	2,405	2,691	1,016	1,025	1,020
Investments in Group undertakings	17	—	—	—	27,504	29,385	26,814
Settlement balances		8,748	9,153	10,871	3,529	4,159	5,335
Derivatives	14	429,005	446,353	937,457	432,812	450,913	938,505
Intangible assets	18	11,832	11,814	12,591	443	210	136
Property, plant and equipment	19	16,143	17,309	16,628	2,301	2,447	2,368
Deferred tax	24	1,790	2,228	2,833	794	1,728	1,323
Prepayments, accrued income and other assets	20	6,237	12,665	11,397	4,760	9,988	5,930
Assets of disposal groups	21	9,542	14,203	—	4,765	7,150	—
Total assets		1,307,330	1,332,981	1,877,930	1,162,197	1,158,615	1,563,600
Liabilities							
Deposits by banks	10	85,220	116,138	181,982	197,973	188,548	201,266
Customer accounts	10	472,325	453,302	453,129	295,358	289,792	229,266
Debt securities in issue	10	164,662	172,413	179,942	128,073	129,814	115,149
Settlement balances		8,501	7,922	8,785	3,343	4,541	5,534
Short positions	22	41,130	36,472	37,172	25,687	23,811	23,827
Derivatives	14	420,969	424,544	909,105	424,503	430,005	911,174
Accruals, deferred income and other liabilities	23	13,734	16,474	16,685	8,058	9,949	9,618
Retirement benefit liabilities	4	2,229	2,622	1,446	23	16	23
Deferred tax	24	1,422	1,187	2,483	—	—	—
Subordinated liabilities	25	32,023	34,717	39,951	29,299	30,513	33,698
Liabilities of disposal groups	21	7,508	10,993	—	2,336	6,108	—
Total liabilities		1,249,723	1,276,784	1,830,680	1,114,653	1,113,097	1,529,555
Non-controlling interests	26	597	1,146	1,292	—	—	—
Owners' equity	27	57,010	55,051	45,958	47,544	45,518	34,045
Total equity		57,607	56,197	47,250	47,544	45,518	34,045
Total liabilities and equity		1,307,330	1,332,981	1,877,930	1,162,197	1,158,615	1,563,600

The accompanying notes on pages 142 to 235, the accounting policies on pages 132 to 141 and the audited sections of the 'Financial review: Risk and balance sheet management' on pages 21 to 119 form an integral part of these financial statements.

The accounts were approved by the Board of directors on 30 March 2011 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 2010

Financial statements

	Group			Bank		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Called-up share capital						
At 1 January	6,609	6,483	5,483	6,609	6,483	5,483
Ordinary shares issued	—	128	1,000	—	128	1,000
Preference shares redeemed	—	(2)	—	—	(2)	—
At 31 December	6,609	6,609	6,483	6,609	6,609	6,483
Share premium account						
At 1 January	25,375	25,175	16,175	25,375	25,175	16,175
Ordinary shares issued	—	8,023	9,000	—	8,023	9,000
Preference shares redeemed	—	(7,823)	—	—	(7,823)	—
At 31 December	25,375	25,375	25,175	25,375	25,375	25,175
Merger reserve						
At 1 January and 31 December	10,881	10,881	10,881	—	—	—
Available-for-sale reserve						
At 1 January	(168)	(1,893)	(35)	(324)	(1,755)	72
Unrealised gains/(losses)	1,765	1,937	(2,585)	1,488	1,455	(2,592)
Realised (gains)/losses	(259)	497	(11)	(32)	534	49
Tax	(421)	(709)	738	(397)	(558)	716
At 31 December	917	(168)	(1,893)	735	(324)	(1,755)
Cash flow hedging reserve						
At 1 January	(129)	(723)	(511)	618	683	(211)
Amount recognised in equity	173	339	(461)	672	(308)	1,292
Amount transferred from equity to earnings	(59)	511	185	(867)	226	(54)
Tax	(66)	(256)	64	59	17	(344)
At 31 December	(81)	(129)	(723)	482	618	683
Foreign exchange reserve						
At 1 January	2,722	4,203	(782)	(305)	(328)	3
Retranslation of net assets	795	(1,842)	7,254	(12)	23	(331)
Foreign currency (losses)/gains on hedges of net assets	(531)	384	(2,630)	—	—	—
Tax	41	(23)	361	—	—	—
At 31 December	3,027	2,722	4,203	(317)	(305)	(328)
Retained earnings						
At 1 January	9,761	1,832	16,472	13,545	3,787	9,567
(Loss)/profit attributable to ordinary and equity preference shareholders	(913)	285	(8,919)	(214)	(540)	(1,309)
Ordinary dividends paid	—	(2,000)	(4,000)	—	(2,000)	(4,000)
Equity preference dividends paid	(60)	(523)	(638)	(60)	(523)	(638)
Actuarial gains/(losses) recognised in retirement benefit schemes						
- gross	176	(3,676)	(1,716)	—	(5)	(2)
- tax	(73)	1,018	464	—	1	—
Capital contribution	1,000	12,500	—	1,000	12,500	—
Share-based payments						
- gross	385	325	177	385	325	177
- tax	6	—	(8)	4	—	(8)
At 31 December	10,282	9,761	1,832	14,660	13,545	3,787
Owners' equity at 31 December	57,010	55,051	45,958	47,544	45,518	34,045

Statements of changes in equity

for the year ended 31 December 2010 continued

	Group			Bank		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Non-controlling interests						
At 1 January	1,146	1,292	152	—	—	—
Currency translation adjustments and other movements	67	(126)	344	—	—	—
Profit attributable to non-controlling interests	29	235	208	—	—	—
Dividends paid	(154)	(261)	(84)	—	—	—
Equity raised	58	9	812	—	—	—
Equity withdrawn and disposals	(549)	(3)	(140)	—	—	—
At 31 December	597	1,146	1,292	—	—	—
Total equity at 31 December	57,607	56,197	47,250	47,544	45,518	34,045
Total comprehensive income/(loss) recognised in the statement of changes in equity is attributable as follows:						
Non-controlling interests	96	109	552	—	—	—
Preference shareholders	60	523	638	60	523	638
Ordinary shareholders	568	(2,058)	(7,894)	637	322	(3,213)
	724	(1,426)	(6,704)	697	845	(2,575)

The accompanying notes on pages 142 to 235, the accounting policies on pages 132 to 141 and the audited sections of the 'Financial review: Risk and balance sheet management' on pages 21 to 119 form an integral part of these financial statements.

Cash flow statements

for the year ended 31 December 2010

Financial statements

	Note	Group			Bank		
		2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Operating activities							
Operating (loss)/profit before tax		(171)	(3)	(9,216)	384	(1,142)	(2,373)
Adjustments for:							
Depreciation and amortisation		1,689	1,587	1,562	561	495	483
Write-down of goodwill and other intangible assets		1	118	8,144	—	—	215
Interest on subordinated liabilities		816	959	1,694	647	672	1,487
Charge for defined benefit pension schemes		489	389	351	8	(4)	8
Pension scheme curtailment gains		(78)	(2,148)	—	—	(1,603)	—
Cash contribution to defined benefit pension schemes		(641)	(744)	(491)	(3)	(1)	(8)
Gain on redemption of own debt		(502)	(2,694)	—	(345)	(2,255)	—
Elimination of foreign exchange differences		(3,107)	5,715	(20,997)	(1,745)	3,623	(16,892)
Other non-cash items		3,806	7,252	5,074	160	2,700	5,004
Net cash inflow/(outflow) from trading activities		2,302	10,431	(13,879)	(333)	2,485	(12,076)
Changes in operating assets and liabilities		29,919	5,498	2,845	29,270	47,357	41,418
Net cash flows from operating activities before tax		32,221	15,929	(11,034)	28,937	49,842	29,342
Income taxes received/(paid)		771	(785)	(886)	507	2	83
Net cash flows from operating activities	32	32,992	15,144	(11,920)	29,444	49,844	29,425
Investing activities							
Sale and maturity of securities		35,032	62,263	37,877	50,043	55,257	30,455
Purchase of securities		(33,632)	(67,751)	(50,360)	(46,230)	(104,885)	(80,693)
Sale of property, plant and equipment		1,918	1,590	2,363	87	77	90
Purchase of property, plant and equipment		(1,954)	(4,255)	(5,153)	(294)	(385)	(719)
Net investment in business interests and intangible assets	33	2,607	(397)	(908)	2,040	(3,125)	(3,264)
Net cash flows from investing activities		3,971	(8,550)	(16,181)	5,646	(53,061)	(54,131)
Financing activities							
Issue of ordinary shares		—	8,151	10,000	—	8,151	10,000
Issue of subordinated liabilities		—	5,000	5,055	—	5,000	5,055
Proceeds of non-controlling interests issued		58	9	812	—	—	—
Capital contribution		1,000	12,500	—	1,000	12,500	—
Redemption of preference shares		—	(7,825)	—	—	(7,825)	—
Redemption of non-controlling interests		(549)	(3)	(140)	—	—	—
Repayment of subordinated liabilities		(880)	(3,200)	(1,035)	(8)	(2,235)	(1,035)
Dividends paid		(214)	(2,784)	(4,722)	(60)	(2,523)	(4,638)
Interest on subordinated liabilities		(895)	(1,151)	(1,511)	(680)	(822)	(1,325)
Net cash flows from financing activities		(1,480)	10,697	8,459	252	12,246	8,057
Effects of exchange rate changes on cash and cash equivalents		756	(4,767)	15,295	321	(3,762)	12,849
Net increase/(decrease) in cash and cash equivalents		36,239	12,524	(4,347)	35,663	5,267	(3,800)
Cash and cash equivalents at 1 January		92,938	80,414	84,761	78,716	73,449	77,249
Cash and cash equivalents at 31 December	36	129,177	92,938	80,414	114,379	78,716	73,449

The accompanying notes on pages 142 to 235, the accounting policies on pages 132 to 141 and the audited sections of the 'Financial review: Risk and balance sheet management' on pages 21 to 119 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 121 - 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 (IFRIC) 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.

The Group has adopted the revised IFRS 3 'Business Combinations' and related revisions to IAS 27 'Consolidated and Separate Financial Statements' issued in January 2008 and also IFRIC 17 'Distributions of Non-cash Assets to Owners' and the IASB's consequential amendments to IFRS 5 'Non-Current Assets Held for Sale and Discontinued Operations' issued in December 2008. They apply to transactions on or after 1 January 2010 and have not resulted in the restatement of previously published financial information. There have been no material acquisitions in the year.

There are a number of other changes to IFRS that were effective from 1 January 2010. They have had no material effect on the Group's financial statements: in April 2009, 'Improvements to IFRS' - making non-urgent but necessary amendments to standards, primarily to remove inconsistencies and to clarify wording; amendments to IAS 39 'Financial Instruments: Recognition and Measurement - limited changes to IAS 39' issued in July 2008 clarified that (a) a one-sided risk can be designated as a hedged risk i.e. an option can be used to hedge a risk above or below a specified threshold and (b) inflation can be a hedged risk but only if the cash flows include a specified inflation portion.

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 up until the Group ceases to control them through a sale or significant change in circumstances. Changes in interest that do not result in a loss of control are recognised in equity.

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. Income is accrued at period end for services provided but not yet charged.

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

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.

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.

Accounting policies *continued*

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. Tax

Provision is made for tax at current enacted rates on taxable profits, arising in income or in equity, taking into account relief for overseas tax where appropriate. Deferred tax 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 and any related tax 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. For collateralised loans and receivables, estimated future cash flows include cash flows that may result from foreclosure less the costs of obtaining and selling the collateral, whether or not foreclosure is probable.

Where, in the course of the orderly realisation of a loan, it is exchanged for equity shares or properties, the exchange is accounted for as the sale of the loan and the acquisition of equity securities or investment properties. Where the Group's interest in equity shares following the exchange is such that the Group controlling an entity, that entity is consolidated.

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. Most debt is written off within five years of the recognition of the initial impairment. It is not the Group's usual practice to write-off all or part of an asset at the time an impairment loss is recognised, it may however, take place in rare circumstances. 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 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.

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. 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. 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. Such objective evidence, indicative that a borrower's financial condition has deteriorated can include for loans that are individually assessed: the non-payment of interest or principal; debt restructuring; probable bankruptcy or liquidation; significant reduction in the value of any security; breach of limits or covenants; and deteriorating trading performance and, for collectively assessed portfolios: the borrowers' payment status and observable data about relevant macroeconomic measures.

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 2010, gross loans and advances to customers totalled £535,003 million (2009 - £548,099 million; 2008 - £626,075 million) and customer loan impairment provisions amounted to £16,682 million (2009 - £11,930 million; 2008 - £6,572 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.

Accounting policies *continued*

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, financial and demographic assumptions are made including price inflation, pension increases, earnings growth and the longevity of scheme members. A range of assumptions 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 sensitivities of the balance sheet and income statement to changes in those assumptions.

A pension asset of £39 million and a liability of £2,229 million were recognised in the balance sheet at 31 December 2010 (2009: asset - £28 million, liability - £2,622 million; 2008: asset - £4 million, liability - £1,446 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 through profit or loss) - principally comprise reverse repurchase agreements (reverse repos) and cash collateral.

Debt securities (held-for-trading, designated as at fair value through 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 through 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 through 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 through profit or loss) - 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 instrument in an active market is the number of units of the instrument held times the current bid price (for financial assets) or offer price (for financial liabilities). In determining the fair value of derivative financial instruments gross long and short positions measured at current mid market prices are adjusted by bid-offer reserves calculated on a portfolio basis. Credit valuation adjustments are made when valuing derivative financial assets to incorporate counterparty credit risk. Adjustments are also made when valuing financial liabilities to reflect the Group's own credit standing. 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. 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 167 to 181.

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 £1,790 million were recognised as at 31 December 2010 (2009 - £2,228 million; 2008 - £2,833 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 18) indicate that sufficient future taxable income will be available against which to offset these recognised deferred tax assets within eight years (2009 - eight years). The Group's cumulative losses are principally attributable to the recent unparalleled market conditions. Deferred tax assets of £298 million (2009 - £26 million; 2008 - £29 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 IASB issued 'Improvements to IFRS' in May 2010 implementing minor changes to IFRS, making non-urgent but necessary amendments to standards, primarily to remove inconsistency and to clarify wording. The revisions are effective for annual periods beginning on or after 1 July 2010 and are not expected to have a material effect on the Group or the Bank.

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.

In October 2010, IFRS 9 was updated to include the classification and measurement of liabilities. It is not markedly different from IAS 39 except for liabilities measured at fair value where the movement is due to changes in credit rating of the preparer it is recognised not in profit or loss but in other comprehensive income.

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 changes relating to the classification and measurement of liabilities carried at fair value will have a less significant effect on the Group. The Group is assessing these impacts which are likely to depend on the outcome of the other phases of IASB's IAS 39 replacement project.

The IASB issued 'Disclosures - Transfers of Financial Assets' (Amendments to IFRS 7 Financial Instruments: Disclosures) in October 2010 to extend the standard's disclosure requirements about derecognition to align with US GAAP. The revisions are effective for annual periods beginning on or after 1 July 2011 and will not affect the financial position or reported performance of the Group or the Bank.

The IASB issued an amendment to IAS 12 'Income Taxes' in December 2010 to clarify that recognition of deferred tax should have regard to the expected manner of recovery or settlement of the asset or liability. The amendment and consequential withdrawal of SIC 21 'Deferred Tax: Recovery of Underlying Assets', effective for annual periods beginning on or after 1 January 2012, is not expected to have a material effect on the Group or the Bank.

The International Financial Reporting Interpretations Committee issued 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.

Notes on the accounts

1 Net interest income

	Group		
	2010 £m	2009 £m	2008 £m
Loans and advances to customers	17,068	18,176	28,240
Loans and advances to banks	348	425	1,302
Debt securities	2,001	2,559	1,871
Interest receivable	19,417	21,160	31,413
Customer accounts: demand deposits	701	668	2,970
Customer accounts: savings deposits	1,410	1,474	2,348
Customer accounts: other time deposits	826	1,756	5,408
Deposits by banks	892	1,533	3,147
Debt securities in issue	2,758	3,509	5,446
Subordinated liabilities	816	959	1,694
Internal funding of trading business	(97)	(282)	(3,109)
Interest payable	7,306	9,617	17,904
Net interest income	12,111	11,543	13,509

2 Non-interest income

	Group		
	2010 £m	2009 £m	2008 £m
Fees and commissions receivable	7,591	7,734	7,483
Fees and commissions payable	(2,060)	(1,972)	(1,733)
Income/(loss) from trading activities (1)			
Foreign exchange	907	1,118	707
Interest rate	2,169	3,805	561
Credit	(406)	(2,867)	(7,691)
Other	691	951	840
	3,361	3,007	(5,583)
Gain on redemption of own debt (2)	502	2,694	—
Other operating income			
Operating lease and other rental income	1,396	1,329	1,232
Changes in the fair value of own debt attributable to own credit (3)	44	(105)	665
Changes in the fair value of securities and other financial assets and liabilities	17	4	(325)
Changes in the fair value of investment properties	(405)	(117)	(86)
Profit on sale of securities	253	312	174
Profit on sale of property, plant and equipment	50	40	177
Profit/(loss) on sale of subsidiaries and associates	675	(16)	417
Dividend income (4)	176	50	50
Share of profits less losses of associated entities	27	(19)	(19)
Other income (5)	(34)	59	(104)
	2,199	1,537	2,181

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.
 - Other: equities, commodities, equity derivatives, commodity contracts and related hedges and funding.
- (2) In May 2010, the Group redeemed certain subordinated debt securities in exchange for cash or senior debt. 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 £502 million were credited to profit or loss. A similar series of exchange and tender offers completed in April 2009 and resulted in a gain of £2,694 million being credited to profit or loss.
- (3) Measured as the change in fair value from movements in the period in the credit risk premium payable by the Group.
- (4) Dividend income includes £124 million (2009 and 2008 - nil) arising from investments in fellow subsidiaries of the RBS Group and consequently subject to the RBS Group's capital management policy (see Note 30).
- (5) Includes income from activities other than banking.

3 Operating expenses

	Group		
	2010 £m	2009 £m	2008 £m
Wages, salaries and other staff costs	6,460	6,436	5,234
Bonus tax	50	141	—
Social security costs	537	424	365
Shared-based compensation	397	329	169
Pension costs			
- defined benefit schemes (see Note 4)	489	389	351
- curtailment gains (see Note 4)	(78)	(2,148)	—
- defined contribution schemes	25	19	23
Staff costs	7,880	5,590	6,142
Premises and equipment	1,909	1,983	1,760
Other administrative expenses	2,996	3,094	2,759
Property, plant and equipment (see Note 19)	1,335	1,288	1,221
Intangible assets (see Note 18)	354	299	341
Depreciation and amortisation	1,689	1,587	1,562
Write-down of goodwill and other intangible assets	1	118	8,144
	14,475	12,372	20,367

Integration costs included in operating expenses comprise expenditure incurred in respect of cost reduction and revenue enhancement programmes connected with acquisitions made by the Group.

	Group		
	2010 £m	2009 £m	2008 £m
Staff costs	155	204	246
Premises and equipment	2	78	25
Other administrative expenses	78	157	194
Depreciation and amortisation	16	18	22
	251	457	487

Restructuring costs included in operating expenses comprise:

	2010	2009	2008
	£m	£m	£m
Staff costs	296	310	111
Premises and equipment	101	42	15
Other administrative expenses	95	50	34
	492	402	160

Divestment costs included in operating expenses comprise:

	2010	2009	2008
	£m	£m	£m
Staff costs	51	—	—
Premises and equipment	6	—	—
Other administrative expenses	25	—	—
	82	—	—

The average number of persons employed, rounded to the nearest hundred, by the Group during the year, excluding temporary staff, was 114,600, (2009 - 121,000; 2008 - 123,000). The number of persons employed by the Group at 31 December, excluding temporary staff, was as follows:

	Group		
	2010	2009	2008
UK Retail	26,100	28,300	31,400
UK Corporate	13,000	12,600	13,500
Wealth	5,200	4,800	5,300
Global Transaction Services	1,100	2,100	2,400
Ulster Bank	4,400	4,600	5,600
US Retail & Commercial	16,500	16,400	17,300
Global Banking & Markets	11,600	10,600	8,600
Central items	3,700	3,200	3,200
Core	81,600	82,600	87,300
Non-Core	2,300	2,900	2,100
Business Services	28,200	31,600	33,400
Total	112,100	117,100	122,800
UK	77,500	81,200	86,600
USA	23,700	25,000	26,000
Europe	5,500	6,800	6,600
Rest of the World	5,400	4,100	3,600
Total	112,100	117,100	122,800

Share-based payments

As described in the Remuneration report in The Royal Bank of Scotland Group plc Annual Report and Accounts 2010, the RBS Group grants share-based awards to employees principally on the following bases:

Award plan	Eligible employees	Nature of award (1)	Vesting conditions (2)	Issue dates
Sharesave	UK, Republic of Ireland, Channel Islands, Gibraltar and Isle of Man	Option to buy shares under employee savings plan	Continuing employment or leavers in certain circumstances	2011 to 2018
Deferred performance awards	All	Awards of ordinary shares	Continuing employment or leavers in certain circumstances	2011 to 2014
Restricted share awards	Senior employees	Awards of conditional shares	Continuing employment or leavers in certain circumstances and/or achievement of performance conditions	2011 to 2014
Long-term incentives (3)	Senior employees	Awards of conditional shares or share options	Continuing employment or leavers in certain circumstances and/or achievement of performance conditions	2011 to 2020

Notes:

- (1) Awards are equity-settled unless international comparability is better served by cash-settled awards.
- (2) All awards have vesting conditions and therefore some may not vest.
- (3) Long-term incentives include the Executive Share Option Plan, the Long-Term Incentive Plan and the Medium-Term Performance Plan.
- (4) The strike price of options and the fair value on granting awards of fully paid shares is the average market price over the five trading days preceding grant date.

3 Operating expenses *continued*

Sharesave

	2010		2009	
	Average exercise price £	Shares under option (million)	Average exercise price £	Shares under option (million)
At 1 January	0.50	1,038	2.88	84
Granted	0.43	147	0.38	1,176
Exercised	0.38	(5)	—	—
Lapsed	0.45	(168)	0.77	(222)
At 31 December	0.48	1,012	0.50	1,038

Options are exercisable within six months of vesting; 23 million were exercisable at 31 December 2010 (2009 - 26 million). The weighted average share price at the date of exercise of options was 45p (2009 - not applicable). At 31 December 2010, exercise prices ranged from 38p to 393p and the average contractual life was 3.3 years (2009 - 38p to 393p and 3.2 years). The fair value of options granted in 2010 was £48 million (2009 - £220 million).

Deferred performance awards

	2010	
	Value at grant £m	Shares awarded (million)
At 1 January	—	—
Granted	1,043	2,755
Forfeited	(34)	(90)
At 31 December	1,009	2,665

None of the share awards vested in 2010. The awards granted in 2010 vest evenly over the following two anniversaries.

Restricted share awards

	2010		2009	
	Value at grant £m	Shares awarded (million)	Value at grant £m	Shares awarded (million)
At 1 January	117	325	48	31
Granted	26	55	94	309
Exercised	(6)	(15)	(16)	(5)
Lapsed	(27)	(30)	(9)	(10)
At 31 December	110	335	117	325

The market value of awards exercised in 2010 was £6 million (2009 - £2 million).

Long-term incentives

	2010			2009		
	Value at grant £m	Shares awarded (million)	Options over shares (million)	Value at grant £m	Shares awarded (million)	Options over shares (million)
At 1 January	122	7	413	79	1	92
Granted	115	247	3	70	8	353
Exercised	—	—	(1)	—	—	—
Lapsed	(18)	(4)	(38)	(27)	(2)	(32)
At 31 December	219	250	377	122	7	413

The market value of awards exercised in 2010 was less than £1 million (2009 - nil). There are vested options over 33 million shares exercisable up to 2020 (2009 - 33 million shares up to 2014).

At 31 December 2010 a provision of £6 million had been made in respect of 16 million share awards and 3 million options over shares that may be cash-settled (2009 - £6 million in respect of 16 million share awards and 3 million options over shares).

The fair value of options granted in 2010 was determined using a pricing model that included: expected volatility of shares determined at the grant date based on historic volatility over a period of up to seven years; an expected option lives that equal the vesting period; no dividends on equity shares; and a risk-free interest rate determined from the UK gilt rates with terms matching the expected lives of the options.

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 principal defined benefit scheme is The Royal Bank of Scotland Retirement Fund (the "Main scheme") which accounts for 88% (2009 - 87%; 2008 - 86%) of the Group's retirement benefit obligations.

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 Main scheme has been closed to new entrants who have instead been offered membership of The Royal Bank of Scotland Retirement Savings Plan, a defined contribution pension scheme. In 2009, pensionable salary increases in the Main scheme and certain other UK and Irish schemes were limited to 2% per annum or CPI inflation if lower.

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)	2010	2009	2008
Discount rate	5.4%	5.9%	6.3%
Expected return on plan assets	6.6%	6.8%	7.1%
Rate of increase in salaries	1.8%	1.8%	3.8%
Rate of increase in pensions in payment	3.1%	3.3%	2.5%
Inflation assumption	3.2%	3.4%	2.6%

Major classes of plan assets as a percentage of total plan assets	2010	2009	2008
Quoted equities	28.1%	39.7%	51.7%
Private equity	4.8%	4.5%	5.8%
Index-linked bonds	23.9%	21.7%	16.7%
Government fixed interest bonds	1.4%	0.7%	1.9%
Corporate and other bonds	25.5%	19.9%	19.0%
Hedge funds	3.7%	4.5%	1.1%
Property	3.6%	3.6%	4.0%
Derivatives	0.8%	(0.1%)	(1.7%)
Cash and other assets	8.1%	5.3%	1.5%
Equity exposure of equity futures	22.5%	9.4%	—
Cash exposure of equity futures	(22.4%)	(9.2%)	—
	100%	100%	100%

The Main scheme, which represents 88% of plan assets at 31 December 2010 (2009 - 88%; 2008 - 89%), is invested in a diversified portfolio of quoted and private equity, government and corporate fixed-interest and index-linked bonds, and other assets including property and hedge funds.

The Main scheme also employs derivative instruments, where appropriate, to achieve a desired asset class exposure or to match assets more closely to liabilities. The value of assets shown reflects the actual physical assets held by the scheme, with any derivative holdings valued on a mark-to-market basis. The return on assets on the total scheme has been based on the asset exposure created allowing for the net impact of the derivatives on the risk and return profile of the holdings.

4 Pension costs *continued*

The Main scheme's holdings of derivative instruments are summarised in the table below:

	2010			2009			2008		
	Notional amounts £m	Fair value Assets £m	Liabilities £m	Notional amounts £m	Fair value Assets £m	Liabilities £m	Notional amounts £m	Fair value Assets £m	Liabilities £m
Inflation rate swaps	2,132	69	8	1,171	75	3	947	1	43
Interest rate swaps	10,727	270	110	4,893	46	114	868	18	—
Total return swaps	466	16	—	—	—	—	—	—	—
Currency swaps	(973)	—	1	—	—	—	—	—	—
Equity futures	4,851	49	14	1,730	37	—	15	—	—
Currency forwards	4,883	35	91	2,908	58	70	1,966	21	267

The investment strategy of other schemes is similar to that of the Main scheme, adjusted to take account of the nature of liabilities, risk appetite of the trustees, size of the scheme and any local regulatory constraints. The use of derivative instruments outside of the Main scheme is not material.

Swaps are part of the management of the inflation and interest rate sensitivity of the Main scheme liabilities. They have been executed at prevailing market rates and within standard market bid/offer spreads. Substantially all swaps are with The Royal Bank of Scotland plc and National Westminster Bank Plc (the "banks"). At 31 December 2010, the gross notional value of the swaps was £12,352 million (2009 - £6,064 million; 2008 - £1,815 million) and had a net positive fair value of

£236 million (2009 - £4 million positive; 2008 - £24 million negative) to the scheme.

Collateral is required on all swap transactions with those between the banks and the Main scheme on terms that do not allow the banks to re-hypothecate. The banks had delivered £210 million of collateral at 31 December 2010 (2009 - held £6 million; 2008 - held £36 million).

Ordinary shares of the ultimate holding company with a fair value of £9 million (2009 - £4 million; 2008 - £15 million) are held by the Group's Main scheme which also holds other financial instruments issued by the Group with a value of £264 million (2009 - £192 million; 2008 - £421 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, allowing for the net impact of derivatives on the risk and return profile:

	2010	2009	2008
Quoted equities	7.9%	8.1%	8.5%
Private equity	7.7%	8.0%	8.5%
Index-linked bonds	4.2%	4.5%	3.9%
Government fixed interest bonds	4.2%	4.5%	4.4%
Corporate and other bonds	5.4%	5.9%	6.1%
Hedge funds	5.3%	4.3%	3.4%
Property	6.7%	6.1%	6.0%
Derivatives	0.0%	0.0%	2.5%
Cash and other assets	3.9%	4.3%	3.4%
Equity exposure of equity futures	7.7%	8.0%	—
Cash exposure of equity futures	4.0%	4.2%	—
Total fund	6.6%	6.8%	7.1%

Post-retirement mortality assumptions (Main scheme)	2010	2009	2008
Longevity at age 60 for current pensioners (years)			
Males	27.2	27.1	26.1
Females	29.6	29.5	26.9
Longevity at age 60 for future pensioners currently aged 40 (years)			
Males	29.3	29.2	28.1
Females	30.8	30.8	28.2

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 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 1 January 2010	18,805	21,399	2,594
Currency translation and other adjustments	50	52	2
Income statement			
Expected return	1,266		(1,266)
Interest cost		1,239	1,239
Current service cost		441	441
Past service cost		75	75
Gains on curtailments		(78)	(78)
	1,266	1,677	411
Statement of comprehensive income			
- Actuarial gains and losses	1,789	1,613	(176)
Contributions by employer	641	—	(641)
Contributions by plan participants and other scheme members	8	8	—
Benefits paid	(817)	(817)	—
Expenses included in service cost	(55)	(55)	—
At 31 December 2010	21,687	23,877	2,190

Net pension deficit/(surplus) comprises	2010 £m	2009 £m	2008 £m
Net assets of schemes in surplus (included in Prepayments, accrued income and other assets, Note 20)	(39)	(28)	(4)
Net liabilities of schemes in deficit	2,229	2,622	1,446
	2,190	2,594	1,442

Notes on the accounts continued

4 Pension costs continued

Curtailed gains of £78 million have been recognised in 2010 arising from changes to pension benefits in a subsidiary's scheme. Curtailed gains of £2,148 million were 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 CPI inflation in any year. The curtailment gains in 2009 were separately disclosed on the face of the income statement due to their size.

The Group expects to contribute £422 million to its defined benefit pension schemes in 2011. Of the net liabilities of schemes in deficit, £155 million (2009 - £146 million; 2008 - £118 million) relates to unfunded schemes.

The most recent funding valuation of the Main UK scheme was 31 March 2007. A funding valuation of the Main UK scheme at 31 March 2010 is currently in progress. The scheme trustees and the RBS Group are in discussion on this valuation and the level of contributions to be paid by the RBS Group and expect to reach agreement by 30 June 2011. The RBS Group expects that in addition to estimated contributions of £300 - £350 million for future accrual of benefits, it will make additional contributions, as yet unquantified, in 2011 and subsequent years to improve the funding position of the scheme.

Cumulative net actuarial losses of £3,680 million (2009 - £3,856 million losses; 2008 - £180 million losses) have been recognised in the statement of comprehensive income.

History of defined benefit schemes

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Fair value of plan assets	21,687	18,805	16,651	20,264	18,894
Present value of defined benefit obligations	23,877	21,399	18,093	20,032	20,865
Net deficit/(surplus)	2,190	2,594	1,442	(232)	1,971
Experience (losses)/gains on plan liabilities	(851)	139	(91)	(204)	(20)
Experience gains/(losses) on plan assets	1,789	1,157	(5,318)	140	585
Actual return/(loss) on pension schemes assets	3,055	2,310	(3,917)	1,437	1,654
Actual return/(loss) on pension schemes assets - %	16.3%	13.9%	(19.2%)	7.6%	9.6%

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 year			Increase/(decrease) in obligation at 31 December		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
0.25% increase in the discount rate	(23)	(31)	(44)	(1,037)	(899)	(786)
0.25% increase in inflation	67	60	86	886	742	696
0.25% additional rate of increase in pensions in payment	42	39	46	580	495	423
0.25% additional rate of increase in deferred pensions	22	17	9	286	229	103
0.25% additional rate of increase in salaries	9	13	33	77	94	199
Longevity increase of 1 year	38	37	34	573	480	337

5 Auditor's remuneration

Amounts paid to the Group's auditor for statutory audit and other services are set out below:

	Group	
	2010 £m	2009 £m
Fees payable for the audit of the Group's annual accounts	4.9	5.0
Fees payable to the auditors and its associates for other services to the Group - the audit of the Bank's subsidiaries pursuant to legislation	7.8	7.9
Total	12.7	12.9

Fees payable to the auditor for non-audit services are disclosed in the consolidated financial statements of The Royal Bank of Scotland Group plc.

6 Tax

	Group		
	2010 £m	2009 £m	2008 £m
Current tax			
Charge for the year	(269)	(198)	(646)
Over provision in respect of prior periods	13	229	257
Relief for overseas tax	—	—	34
	(256)	31	(355)
Deferred tax			
(Charge)/credit for the year	(389)	658	849
(Under)/over provision in respect of prior periods	(68)	(166)	11
Tax (charge)/credit for the year	(713)	523	505

The actual tax (charge)/credit differs from the expected tax credit computed by applying the standard rate of UK corporation tax of 28% (2009 -28%; 2008 - 28.5%) as follows:

	2010 £m	2009 £m	2008 £m
Expected tax credit	48	1	2,627
Non-deductible goodwill impairment	—	(33)	(1,949)
Unrecognised timing differences	11	274	(274)
Items not allowed for tax			
- losses on strategic disposals and write-downs	(95)	(47)	(28)
- other	(300)	(288)	(266)
Non-taxable items			
- gain on sale of Global Merchant Services	221	—	—
- gain on redemption of own debt	1	626	—
- other	218	134	305
Taxable foreign exchange movements	(5)	39	(161)
Foreign profits taxed at other rates	(496)	(232)	(4)
UK tax rate change - deferred tax impact	31	—	(1)
Losses in year where no deferred tax asset recognised	(292)	(14)	(12)
Adjustments in respect of prior years (1)	(55)	63	268
Actual tax (charge)/credit	(713)	523	505

Notes:

- (1) Prior year tax adjustments include releases of tax provisions in respect of structured transactions and investment disposals and adjustments to reflect submitted tax computations in the UK and overseas.
- (2) In the Budget on 22 June 2010, the UK Government proposed, amongst other things, to reduce the rate of Corporation Tax rates in four annual decrements of 1% with effect from 1 April 2011. The first decrement from 28% to 27% was enacted in the Finance (No 2) Act 2010 on 27 July 2010. Accordingly, the closing deferred tax assets and liabilities have been calculated at the rate of 27%. An additional 1% decrement, also effective from 1 April 2011, was announced by the UK Government in the Budget on 23 March 2011. The impact of this further change is estimated as giving rise to a tax credit of £20 million, which will be recognised in the accounts for 2011.

7 Profit attributable to preference shareholders

	Group		
	2010 £m	2009 £m	2008 £m
Non-cumulative preference shares of US\$0.01	42	267	350
Non-cumulative preference shares of €0.01	18	179	205
Non-cumulative preference shares of £1	—	77	83
Total	60	523	638

Note:

- (1) Between 1 January 2011 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 2011.

8 Ordinary dividends

The Bank did not pay an ordinary dividend in 2010 (2009 - £2,000 million; 2008 - £4,000 million).

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 for the Bank has been presented as a primary financial statement. Of the loss attributable to ordinary shareholders, £274 million (2009 - £1,063 million; 2008 - £1,947 million) has been dealt with in the accounts of the Bank.

Notes on the accounts continued

10 Financial instruments - classification

The following tables analyse the Group's financial assets and liabilities in accordance with the categories of financial instruments in IAS 39. Assets and liabilities outside the scope of IAS 39 are shown separately.

2010	Group									Total £m
	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		
Assets										
Cash and balances at central banks	—	—	—	—	49,838	—	—	—	—	49,838
Loans and advances to banks										
- reverse repos	38,215	—	—	—	2,315	—	—	—	—	40,530
- other (1)	28,550	186	—	—	18,239	—	—	—	—	46,975
Loans and advances to customers										
- reverse repos	41,110	—	—	—	8,050	—	—	—	—	49,160
- other	21,121	1,092	—	—	436,511	—	10,437	—	—	469,161
Debt securities	91,771	141	—	67,437	6,680	—	—	—	—	166,029
Equity shares	482	496	—	1,362	—	—	—	—	—	2,340
Settlement balances	—	—	—	—	8,748	—	—	—	—	8,748
Derivatives	424,380	—	4,625	—	—	—	—	—	—	429,005
Intangible assets	—	—	—	—	—	—	—	11,832	—	11,832
Property, plant and equipment	—	—	—	—	—	—	—	16,143	—	16,143
Deferred tax	—	—	—	—	—	—	—	1,790	—	1,790
Prepayments, accrued income and other assets	—	—	—	—	30	—	—	6,207	—	6,237
Assets of disposal groups	—	—	—	—	—	—	—	9,542	—	9,542
	645,629	1,915	4,625	68,799	530,411	—	10,437	45,514	—	1,307,330
Liabilities										
Deposits by banks										
- repos	20,555	—	—	—	—	8,039	—	—	—	28,594
- other (2)	32,788	—	—	—	—	23,838	—	—	—	56,626
Customer accounts										
- repos	52,952	—	—	—	—	24,814	—	—	—	77,766
- other (3)	13,464	4,824	—	—	—	376,271	—	—	—	394,559
Debt securities in issue (4,5)	7,725	11,013	—	—	—	145,924	—	—	—	164,662
Settlement balances	—	—	—	—	—	8,501	—	—	—	8,501
Short positions	41,130	—	—	—	—	—	—	—	—	41,130
Derivatives	418,549	—	2,420	—	—	—	—	—	—	420,969
Accruals, deferred income and other liabilities	—	—	—	—	—	1,793	458	11,483	—	13,734
Retirement benefit liabilities	—	—	—	—	—	—	—	2,229	—	2,229
Deferred tax	—	—	—	—	—	—	—	1,422	—	1,422
Subordinated liabilities	—	468	—	—	—	31,555	—	—	—	32,023
Liabilities of disposal groups	—	—	—	—	—	—	—	7,508	—	7,508
	587,163	16,305	2,420	—	—	620,735	458	22,642	—	1,249,723
Equity	—	—	—	—	—	—	—	—	—	57,607
	—	—	—	—	—	—	—	—	—	1,307,330

For notes relating to this table refer to page 155.

2009	Group								Total £m
	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	
Assets									
Cash and balances at central banks	—	—	—	—	27,060	—	—	—	27,060
Loans and advances to banks									
- reverse repos	26,886	—	—	—	3,944	—	—	—	30,830
- other (1)	22,539	178	—	—	14,894	—	—	—	37,611
Loans and advances to customers									
- reverse repos	26,313	—	—	—	7,499	—	—	—	33,812
- other	15,595	1,354	—	—	472,179	—	13,229	—	502,357
Debt securities	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 tax	—	—	—	—	—	—	—	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									
- repos	20,962	—	—	—	—	14,620	—	—	35,582
- other (2)	38,437	—	—	—	—	42,119	—	—	80,556
Customer accounts									
- repos	41,520	—	—	—	—	24,505	—	—	66,025
- other (3)	12,786	3,450	—	—	—	371,041	—	—	387,277
Debt securities in issue (4,5)	4,084	10,087	—	—	—	158,242	—	—	172,413
Settlement balances	—	—	—	—	—	7,922	—	—	7,922
Short positions	36,472	—	—	—	—	—	—	—	36,472
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 tax	—	—	—	—	—	—	—	1,187	1,187
Subordinated liabilities	—	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 155.

Notes on the accounts continued

10 Financial instruments - classification continued

2008	Group								Total £m
	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	
Assets									
Cash and balances at central banks	—	—	—	—	6,806	—	—	—	6,806
Loans and advances to banks									
- reverse repos	26,059	—	—	—	5,377	—	—	—	31,436
- other (1)	34,898	—	—	—	13,053	—	—	—	47,951
Loans and advances to customers									
- reverse repos	22,539	—	—	—	5,433	—	—	—	27,972
- other	29,634	1,767	—	—	545,677	—	14,453	—	591,531
Debt securities	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 tax	—	—	—	—	—	—	—	2,833	2,833
Prepayments, accrued income and other assets	—	—	—	—	32	—	—	11,365	11,397
	<u>1,148,683</u>	<u>4,641</u>	<u>4,254</u>	<u>63,477</u>	<u>599,005</u>	<u>—</u>	<u>14,453</u>	<u>43,417</u>	<u>1,877,930</u>
Liabilities									
Deposits by banks									
- repos	43,206	—	—	—	—	22,800	—	—	66,006
- other (2)	43,732	—	—	—	—	72,244	—	—	115,976
Customer accounts									
- repos	39,942	—	—	—	—	14,153	—	—	54,095
- other (3)	17,875	2,707	—	—	—	378,452	—	—	399,034
Debt securities in issue (4,5)	3,991	12,164	—	—	—	163,787	—	—	179,942
Settlement balances	—	—	—	—	—	8,785	—	—	8,785
Short positions	37,172	—	—	—	—	—	—	—	37,172
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 tax	—	—	—	—	—	—	—	2,483	2,483
Subordinated liabilities	—	708	—	—	—	39,243	—	—	39,951
	<u>1,091,724</u>	<u>15,579</u>	<u>3,559</u>	<u>—</u>	<u>—</u>	<u>701,083</u>	<u>22</u>	<u>18,713</u>	<u>1,830,680</u>
Equity									<u>47,250</u>
									<u>1,877,930</u>

The above includes amounts due from/to:

Group	2010		2009		2008	
	Holding company £m	Fellow subsidiaries £m	Holding company £m	Fellow subsidiaries £m	Holding company £m	Fellow subsidiaries £m
Assets						
Loans and advances to banks		4,848		5,274		7,297
Loans and advances to customers	—	1,946	4	1,945	1,828	2,656
Derivatives	231	17,238	446	31,574	361	56,063
Liabilities						
Deposits by banks		6,626		8,888		6,327
Customer accounts	4,507	4,427	16,494	2,297	15,801	2,488
Derivatives	1,475	12,780	1,169	28,175	1,168	53,222
Subordinated liabilities	15,028	—	14,966	—	11,572	—

Notes:

- (1) Includes items in the course of collection from other banks of £1,958 million (2009 - £2,474 million; 2008 - £2,779 million).
- (2) Includes items in the course of transmission to other banks of £577 million (2009 - £770 million; 2008 - £542 million).
- (3) The carrying amount of other customer accounts designated as at fair value through profit or loss is £233 million higher (2009 - £101 million higher; 2008 - £44 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.
- (4) Comprises bonds and medium term notes of £109,528 million (2009 - £92,612 million; 2008 - £70,153 million) and certificates of deposit and other commercial paper of £55,134 million (2009 - £79,801 million; 2008 - £109,789 million).
- (5) The carrying amount is £751 million (2009 - £810 million; 2008 - £1,145 million) lower than the principal amount.
- (6) During 2009, the Group reclassified financial assets from the held-for-trading category into the loans and receivables category, and in 2008 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 pages 161 to 164).

Notes on the accounts continued

10 Financial instruments - classification continued

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.

2010	Bank							Total £m
	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	
Assets								
Cash and balances at central banks	—	—	—	—	44,921	—	—	44,921
Loans and advances to banks								
- reverse repos	27,359	—	—	—	44	—	—	27,403
- other (1)	29,228	186	—	—	44,148	—	—	73,562
Loans and advances to customers								
- reverse repos	29,900	—	—	—	1,324	—	—	31,224
- other	28,237	561	—	—	289,157	—	—	317,955
Debt securities	55,715	1,011	—	53,825	78,657	—	—	189,208
Equity shares	466	197	—	353	—	—	—	1,016
Investments in Group undertakings	—	—	—	—	—	—	27,504	27,504
Settlement balances	—	—	—	—	3,529	—	—	3,529
Derivatives	428,823	—	3,989	—	—	—	—	432,812
Intangible assets	—	—	—	—	—	—	443	443
Property, plant and equipment	—	—	—	—	—	—	2,301	2,301
Deferred tax	—	—	—	—	—	—	794	794
Prepayments, accrued income and other assets	—	—	—	—	—	—	4,760	4,760
Assets of disposal groups	—	—	—	—	—	—	4,765	4,765
	599,728	1,955	3,989	54,178	461,780	—	40,567	1,162,197
Liabilities								
Deposits by banks								
- repos	17,551	—	—	—	—	2,224	—	19,775
- other (2)	36,781	—	—	—	—	141,417	—	178,198
Customer accounts								
- repos	20,384	—	—	—	—	98	—	20,482
- other (3)	35,817	1,628	—	—	—	237,431	—	274,876
Debt securities in issue (4,5)	7,726	11,006	—	—	—	109,341	—	128,073
Settlement balances	—	—	—	—	—	3,343	—	3,343
Short positions	25,687	—	—	—	—	—	—	25,687
Derivatives	423,494	—	1,009	—	—	—	—	424,503
Accruals, deferred income and other liabilities	—	—	—	—	—	1,094	6,964	8,058
Retirement benefit liabilities	—	—	—	—	—	—	23	23
Subordinated liabilities	—	468	—	—	—	28,831	—	29,299
Liabilities of disposal groups	—	—	—	—	—	—	2,336	2,336
	567,440	13,102	1,009	—	—	523,779	9,323	1,114,653
Equity	—	—	—	—	—	—	—	47,544
	—	—	—	—	—	—	—	1,162,197

For notes to this table refer to page 160.

The above includes amounts due from/to:

2010	Bank		
	Holding company £m	Fellow subsidiaries £m	Subsidiaries £m
Assets			
Loans and advances to banks		169	39,958
Loans and advances to customers	—	5,159	122,658
Derivatives	231	17,224	6,630
Liabilities			
Deposits by banks		311	138,295
Customer accounts	4,507	6,090	158,561
Derivatives	1,475	12,770	4,110
Subordinated liabilities	15,028	—	—

Notes on the accounts continued

10 Financial instruments - classification continued

2009	Bank								Total £m
	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		
Assets									
Cash and balances at central banks	—	—		—	21,099				21,099
Loans and advances to banks									
- reverse repos	18,350	—		—	1,494				19,844
- other (1)	23,913	178		—	33,430				57,521
Loans and advances to customers									
- reverse repos	21,601	—		—	1,588				23,189
- other	22,156	817		—	292,386				315,359
Debt securities	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 tax							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									
- repos	20,316	—				4,675			24,991
- other (2)	37,659	—				125,898			163,557
Customer accounts									
- repos	25,514	—				1,340			26,854
- other (3)	26,971	659				235,308			262,938
Debt securities in issue (4,5)	4,483	10,059				115,272			129,814
Settlement balances	—	—				4,541			4,541
Short positions	23,811	—							23,811
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

The above includes amounts due from/to:

2009	Bank		
	Holding company £m	Fellow subsidiaries £m	Subsidiaries £m
Assets			
Loans and advances to banks		5,192	28,418
Loans and advances to customers	4	1,626	101,223
Derivatives	446	31,554	7,233
Liabilities			
Deposits by banks		—	113,240
Customer accounts	16,494	1,363	142,266
Derivatives	1,169	28,170	5,912
Subordinated liabilities	14,966	—	—

For notes relating to this table refer to page 160.

2008	Bank						Other financial instruments (amortised cost) £m	Non financial assets/liabilities £m	Total £m
	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				
Assets									
Cash and balances at central banks	—	—	—	—	3,714	—	—	—	3,714
Loans and advances to banks									
- reverse repos	18,963	—	—	—	300	—	—	—	19,263
- other (1)	37,126	—	—	—	35,328	—	—	—	72,454
Loans and advances to customers									
- reverse repos	20,126	—	—	—	2,438	—	—	—	22,564
- other	39,020	1,160	—	—	264,296	—	—	—	304,476
Debt securities	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
	<u>1,118,318</u>	<u>2,094</u>	<u>3,796</u>	<u>42,427</u>	<u>360,394</u>	<u>—</u>	<u>—</u>	<u>36,571</u>	<u>1,563,600</u>
Liabilities									
Deposits by banks									
- repos	41,781	—	—	—	—	10,509	—	—	52,290
- other (2)	43,345	—	—	—	—	105,631	—	—	148,976
Customer accounts									
- repos	17,673	—	—	—	—	6,368	—	—	24,041
- other (3)	28,505	170	—	—	—	176,550	—	—	205,225
Debt securities in issue (4,5)	3,993	12,099	—	—	—	99,057	—	—	115,149
Settlement balances	—	—	—	—	—	5,534	—	—	5,534
Short positions	23,827	—	—	—	—	—	—	—	23,827
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
	<u>1,069,572</u>	<u>12,977</u>	<u>986</u>	<u>—</u>	<u>—</u>	<u>437,726</u>	<u>8,294</u>	<u>—</u>	<u>1,529,555</u>
Equity									34,045
									<u>1,563,600</u>

For notes to this table refer to page 160.

Notes on the accounts continued

10 Financial instruments - classification continued

The above includes amounts due from/to:

2008	Bank		
	Holding company £m	Fellow subsidiaries £m	Subsidiaries £m
Assets			
Loans and advances to banks		6,862	29,619
Loans and advances to customers	1,828	2,632	39,908
Derivatives	361	56,054	12,445
Liabilities			
Deposits by banks		5,715	63,198
Customer accounts	15,800	1,940	68,282
Derivatives	1,168	52,954	11,141
Subordinated liabilities	11,572	—	—

Amounts included in the consolidated income statement:

	Group		
	2010 £m	2009 £m	2008 £m
Gains on financial assets/liabilities designated as at fair value through profit or loss	169	1,027	198
Gains/(losses) on disposal or settlement of loans and receivables	78	(16)	4

Notes:

- (1) Includes items in the course of collection from other banks of £463 million (2009 - £426 million; 2008 - £484 million).
- (2) Includes items in the course of transmission to other banks of £266 million (2009 - £319 million; 2008 - £312 million).
- (3) The carrying amount of other customer accounts designated as at fair value through profit or loss is £57 million higher (2009 - £28 million higher; 2008 - £2 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.
- (4) Comprises bonds and medium term notes of £89,492 million (2009 - £70,482 million; 2008 - £40,595 million) and certificates of deposit and other commercial paper of £38,576 million (2009 - £59,332 million; 2008 - £74,553 million).
- (5) The carrying amount is £560 million (2009 - £714 million; 2008 - £1,055 million) lower than the principal amount.
- (6) During 2009, the Bank reclassified financial assets from the held-for-trading category into the loans and receivables category, and in 2008 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 pages 165 and 166).

Reclassification of financial instruments

The Group and Bank 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, fair value and the effect on profit or loss of reclassifications undertaken by the Group in 2008 and 2009. There were no reclassifications in 2010.

	Group						
	31 December 2010		Amount recognised in profit or loss		Amount that would have been recognised had reclassification not occurred £m	Reduction in profit or loss as result of reclassification £m	
	Carrying value £m	Fair value £m	Income £m	Impairment releases/(losses) £m			
2010							
Reclassified from HFT to LAR							
Loans							
- Leveraged finance	1,100	963	88	59	317	170	
- Corporate and other loans	4,110	3,298	139	(205)	166	232	
	5,210	4,261	227	(146)	483	402	
Debt securities							
- CDO	22	22	1	—	1	—	
- RMBS	925	747	28	(1)	146	119	
- CMBS	487	430	8	(8)	97	97	
- CLOs	389	340	11	(3)	65	57	
- Other ABS	546	487	(2)	—	(1)	1	
- Other	639	652	19	—	79	60	
	3,008	2,678	65	(12)	387	334	
	8,218	6,939	292	(158)	870	736	
Reclassified from HFT to AFS (1)							
Debt securities							
- CDO	342	342	24	1	97	72	
- RMBS	2,018	2,018	40	(4)	34	(2)	
- CMBS	52	52	5	—	11	6	
- CLOs	1,645	1,645	153	—	214	61	
- Other ABS	338	338	19	—	17	(2)	
	4,395	4,395	241	(3)	373	135	
Reclassified from AFS to LAR (2)							
Debt securities							
	422	380	(31)	(50)	(81)	—	
	13,035	11,714	502	(211)	1,162	871	

Notes:

- (1) The amount taken to the AFS reserves was £137 million.
(2) The amount that would have been taken to the AFS reserves if reclassification had not occurred is £98 million.

Notes on the accounts continued

10 Financial instruments - classification continued

	Group					
	31 December 2009		Amount recognised in profit or loss		Amount that would have been recognised had reclassification not occurred	Reduction in profit or loss as result of reclassification
	Carrying value £m	Fair value £m	Income £m	Impairment losses £m		
2009						
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
	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	—
	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 following table provides information for reclassifications made in 2009.

	Group										
	2009 - on reclassification			31 December 2009		Gains/ (losses) up to the date of reclassi- fication £m	2009		Additional amount that would have been recognised had reclassification not occurred £m	Reduction in profit or loss as result of reclassi- fication £m	2008 Gains/(losses) recognised in the income statement in prior period £m
	Carrying value £m	Effective interest rate %	Expected cash flows £m	Carrying value £m	Fair value £m		Income £m	Impairment losses £m			
Reclassified 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
	1,740		2,640	887	924	(103)	(44)	(251)	(256)	39	(62)
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)
	1,995		2,989	1,077	1,112	(136)	(44)	(251)	(258)	37	(101)

Notes on the accounts continued

10 Financial instruments - classification continued

The following table provides information for reclassifications made in 2008.

	Group										
	2008 - after reclassification			31 December 2008		Gains/(losses) up to the date of reclassification £m	2008			Increase in profit or loss as result of reclassification £m	2007
	Carrying value £m	Effective interest rate %	Expected cash flows £m	Carrying value £m	Fair value £m		After reclassification	Impairment losses £m	reclassification not occurred £m		Gains/(losses) recognised in the income statement in prior period £m
Reclassified from HFT to LAR											
Loans											
- Leveraged finance	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)
	8,627		13,661	10,113	7,611	(533)	656	—	(1,720)	2,376	(205)
Debt securities											
- CDO	215	4.92	259	236	221	4	5	—	(11)	16	5
- 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)
- Other ABS	1,649	5.24	2,547	1,485	1,296	(61)	116	—	(73)	189	3
- Other	2,538	2.62	2,764	2,602	2,388	72	3	—	(166)	169	94
	8,557		10,827	9,206	7,767	(156)	449	—	(928)	1,377	57
	17,184		24,488	19,319	15,378	(689)	1,105	—	(2,648)	3,753	(148)
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)
- 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)
- Other ABS	620	4.36	1,056	618	618	(41)	1	—	—	1	(8)
- 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)
Reclassified from AFS to LAR											
Debt securities (2)											
	694	1.38	760	1,017	957	(12)	6	—	6	—	—
	28,182		41,153	29,201	25,200	(1,746)	(56)	(51)	(4,788)	4,681	(309)

Notes:

(1) The amount taken to AFS reserves was £(958) million.

(2) The amount that would have been in AFS reserves if reclassification had not occurred is £(37) million.

The table below shows the carrying value and fair value of reclassifications undertaken by the Bank in 2008 and 2009.

	Bank			
	31 December 2010		31 December 2009	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Reclassified from HFT to LAR				
Loans				
- Leveraged finance	1,095	959	2,508	2,224
- Corporate and other loans	5,087	4,371	6,045	5,013
	6,182	5,330	8,553	7,237
Debt securities				
- CDO	22	22	21	21
- RMBS	925	747	1,284	964
- CMBS	487	430	492	345
- CLOs	389	340	607	500
- Other ABS	546	487	1,030	965
- Other	639	652	876	871
	3,008	2,678	4,310	3,666
	9,190	8,008	12,863	10,903
Reclassified from HFT to AFS (1)				
Debt securities				
- CDO	342	342	238	238
- RMBS	2,018	2,018	3,042	3,042
- CMBS	52	52	63	63
- CLOs	1,645	1,645	1,923	1,923
- Other ABS	338	338	508	508
- Other	—	—	1	1
	4,395	4,395	5,775	5,775
Reclassified from AFS to LAR (2)				
Debt securities				
	422	380	869	745
	14,007	12,783	19,507	17,423

Notes:

(1) The amount taken to AFS reserves was £137 million (2009 - £763 million).

(2) The amount that would have been taken to AFS reserves if reclassification had not occurred is £98 million (2009 - £(73) million).

The following table provides information for reclassifications made in 2009.

	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
	1,995		2,989	1,077	1,112

Notes on the accounts continued

10 Financial instruments - classification continued

The following table provides information for reclassifications made in 2008.

	Bank				
	2008 - on reclassification			31 December 2008	
	Carrying value £m	Effective interest rate %	Expected cash flows £m	Carrying value £m	Fair value £m
Reclassified from HFT to LAR					
Loans					
- Leveraged finance	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
	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
	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 reserves if reclassification had not occurred is £(37) million.

11 Financial instruments - valuation

Valuation of financial instruments carried at fair value

Control environment

Common valuation policies, procedures, frameworks and models apply across the RBS Group. Therefore for the most part, discussions on these aspects below reflect those in the RBS Group as relevant for businesses and operations in the Group.

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 of 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.

All IPV variances are classified as either 'hard' or 'soft'. A variance is hard where the independent information represents tradable or liquid prices, and soft where it does not. Adjustments are required for all hard variances and for aggressive soft variances, but with conservative variances not requiring adjustment.

Monthly meetings are held between the business and the support functions to discuss the results of the IPV and reserves process in detail.

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 book. The IPV control includes formalised reporting and escalation of any valuation differences in breach of established thresholds. The Global Pricing Unit (GPU) determines IPV policy, monitors adherence to that policy, and performs additional independent reviews on highly subjective valuation issues for GBM and Non-Core.

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 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 (QuaRC). Potential valuation uncertainty is a key input in determining model review priorities at these meetings. The QuaRC within Group Risk, 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.

Senior management valuations control committees meet formally on a monthly basis 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 these committees. The committees include valuation specialists representing several independent review functions including market risk, QuaRC and finance.

The RBS Group Executive Valuation Committee discusses the issues escalated by the Modelled Product Review Committee, GBM and Non-Core senior management Valuations Control Committee and other relevant issues including the APS credit derivative valuation. The committee covers key material and subjective valuation issues within the trading business. The committee will provide ratification to the appropriateness of areas with high levels of residual valuation uncertainty. Committee membership includes the RBS Group Finance Director, the RBS Group Chief Accountant, RBS Group Global Head of Market and Insurance Risk, GBM Chief Finance Officer and Non-Core Chief Finance Officer, and representation from front office trading and finance.

Valuation issues, adjustments and reserves are reported to the GBM, Non-Core and Group Audit Committees. Key judgmental issues are described in reports submitted to these Audit Committees.

New products

The Group has formal review procedures to ensure that new products, asset classes and risk types are appropriately reviewed to ensure, amongst other things, that valuation is appropriate. Group Operational Risk owns the Group New Product Approval Process, the scope of which includes new business, markets, models, risks and structures.

During 2010, the Group made a significant and ongoing investment into enhancing its already robust control environment. This included a new global IPV and reserving tool, which partly automates the process of carrying out IPV and consolidation of reserves into a single central portal.

Valuation hierarchy

There is a process to review and control the classification of financial instruments into the three level hierarchy established by IFRS 7. Some instruments may not easily fall into a level of the fair value hierarchy per IFRS 7 (see page 171) and judgment may be required as to which level the instrument is classified.

Initial classification of a financial instrument is carried out by the Business Unit Control (BUC) team following the principles in IFRS. BUC base their judgment on information gathered during the IPV process for instruments which include the sourcing of independent prices and model inputs. The quality and completeness of the information gathered in the IPV process gives an indication as to the liquidity and valuation uncertainty of an instrument.

These initial classifications are challenged by GPU and are subject to further review by local Chief Finance Officer, divisional Chief Finance Officer and the RBS Group Chief Accountant. Particular attention is paid during the review processes upon instruments crossing from one level to another, new instrument classes or products, instruments that are generating significant profit and loss and instruments where valuation uncertainty is high.

11 Financial instruments - valuation *continued*

Valuation techniques

The Group derives fair value of its instruments differently depending on whether the instrument is a non-modelled or modelled product.

Non-modelled products

Non-modelled products are valued directly from a price input and are typically valued on a position by position basis and include cash, equities and most debt securities.

Modelled products

Modelled products are those that are valued using a pricing model, ranging in complexity from comparatively vanilla products such as interest rate swaps and options (e.g. interest rate caps and floors) through to more complex derivatives. The valuation of modelled products requires an appropriate model and inputs into this model. Sometimes models are also used to derive inputs (e.g. to construct volatility surfaces). The Group uses a number of modelling methodologies.

Inputs to valuation models

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. The principal inputs to these valuation techniques are as follows:

- 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 credit default swaps 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 interbank 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 asset-backed-securities 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.

The Group may use consensus prices for the source of independent pricing for some assets. The consensus service encompasses the equity, interest rate, currency, commodity, credit, property, fund and bond markets, providing comprehensive matrices of vanilla prices and a wide selection of exotic products. GBM and Non-Core contribute to consensus pricing services where there is a significant interest either from a positional point of view or to test models for future business use. Data sourced from consensus pricing services is used for a combination of control processes including direct price testing, evidence of observability and model testing. In practice this means that the Group submits prices for all material positions for which a service is available.

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. 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.

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.

The table below shows the Group's valuation reserves and adjustments.

	2010 £m	2009 £m	2008 £m
Credit valuation adjustments			
Monoline insurers	800	1,925	3,289
Credit derivative product companies.	490	495	746
Other counterparties	1,609	1,401	1,089
	2,899	3,821	5,124
Bid-offer and liquidity reserves	2,607	2,532	2,547
	5,506	6,353	7,671

Credit valuation adjustments (CVA)

Credit valuation adjustments 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, balance sheet management - Other risk exposures - Credit valuation adjustments (pages 105 to 109).

Bid-offer and liquidity reserves

Fair value 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 by way of 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-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 hedges based on vanilla instruments.

Where there is limited bid-offer information for a product, a conservative approach is adopted, taking into account pricing approach and risk management strategy.

Derivative discounting

The market convention for some derivative products has moved to pricing collateralised derivatives using the overnight indexed swap (OIS) curve, which reflects the interest rate typically paid on cash collateral. In order to reflect observed market practice the Group's valuation approach for the substantial portion of its collateralised derivatives was amended to use OIS. Previously the Group had discounted these collateralised derivatives based on LIBOR. The rate for discounting uncollateralised derivatives was also changed in line with observable market pricing. The change results in a net increase in income from trading activities of £127 million for 2010.

Notes on the accounts continued

11 Financial instruments - valuation continued

Amounts deferred on initial recognition

On initial recognition financial assets and liabilities are 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 becomes observable; or when the transaction matures or is closed out as appropriate. At 31 December 2010, net gains of £156 million (2009 - £159 million; 2008 - £42 million) were carried forward in the balance sheet. During the year net gains of £96 million (2009 - £138 million; 2008 - £25 million) were deferred and £99 million (2009 - £21 million; 2008 - £47 million) were recognised in the income statement.

Own credit

The Group takes into account the effect of its own credit standing when valuing financial liabilities recorded at fair value in accordance with IFRS. 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 credit default swap prices.

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 own credit adjustment for fair value does not alter cash flows, is not used for performance management and is disregarded for regulatory capital reporting processes and will reverse over time as the liabilities mature.

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, or provided the liability is not repaid at a premium or a discount.

The table below shows the Group's own credit adjustments on own liabilities.

	Debt securities in issue (1) £m	Subordinated liabilities £m	Total £m	Derivatives £m	Total £m
Cumulative own credit adjustment					
2010	1,027	138	1,165	444	1,609
2009	1,030	267	1,297	417	1,714
2008	805	817	1,622	360	1,982

Carrying values of underlying liabilities

	£bn	£bn	£bn
2010	18.7	0.5	19.2
2009	14.2	0.6	14.8
2008	16.2	1.0	17.2

Note:

(1) Consists of wholesale and retail note issuances.

Valuation hierarchy

The table below shows financial instruments carried at fair value in the Group's balance sheet by valuation hierarchy - level 1, level 2 and level 3.

	2010				2009				2008			
	Level 1 £bn	Level 2 £bn	Level 3 £bn	Total £bn	Level 1 £bn	Level 2 £bn	Level 3 £bn	Total £bn	Level 1 £bn	Level 2 £bn	Level 3 £bn	Total £bn
Assets												
Loans and advances to banks	—	66.6	0.4	67.0	—	49.6	—	49.6	—	61.0	—	61.0
Loans and advances to customers	—	63.1	0.2	63.3	—	42.8	0.5	43.3	—	50.8	3.1	53.9
Debt securities	92.7	59.3	7.3	159.3	94.9	76.0	4.0	174.9	66.3	93.6	6.1	166.0
Equity shares	0.7	1.0	0.6	2.3	0.7	0.9	0.8	2.4	0.6	1.0	1.1	2.7
Derivatives	1.7	421.8	5.5	429.0	0.3	440.5	5.5	446.3	1.4	929.7	6.3	937.4
	95.1	611.8	14.0	720.9	95.9	609.8	10.8	716.5	68.3	1,136.1	16.6	1,221.0
Of which is classified as AFS ⁽⁸⁾												
Debt securities	35.6	27.5	4.3	67.4	35.2	35.0	1.3	71.5	16.2	43.1	2.3	61.6
Equity shares	0.3	0.9	0.2	1.4	0.3	0.9	0.6	1.8	0.1	1.0	0.7	1.8
Total AFS assets ⁽⁸⁾	35.9	28.4	4.5	68.8	35.5	35.9	1.9	73.3	16.3	44.1	3.0	63.4
Liabilities												
Deposits by banks and customers	—	124.4	0.2	124.6	—	117.1	0.1	117.2	—	147.1	0.3	147.4
Debt securities in issue	—	18.5	0.2	18.7	—	13.6	0.6	14.2	—	15.4	0.8	16.2
Short positions	33.5	6.8	0.8	41.1	24.4	11.9	0.2	36.5	32.0	5.2	—	37.2
Derivatives	0.2	419.4	1.4	421.0	0.2	422.7	1.6	424.5	0.7	905.6	2.8	909.1
Other financial liabilities ⁽³⁾	—	0.5	—	0.5	—	0.6	—	0.6	—	0.7	0.3	1.0
	33.7	569.6	2.6	605.9	24.6	565.9	2.5	593.0	32.7	1,074.0	4.2	1,110.9

For the notes to this table refer to page 173.

Notes on the accounts continued

11 Financial instruments - valuation continued

The table below analyses level 3 balances and related sensitivities.

	2010			2009			Assumptions
	Balance £bn	Sensitivity (2)		Balance £bn	Sensitivity (2)		
		Favourable £m	Unfavourable £m		Favourable £m	Unfavourable £m	
Assets							
Loans and advances	0.6	70	(60)	0.5	40	(10)	Credit spreads, indices
Debt securities							
MBS (4)	0.7	110	(80)	0.5	60	(20)	Prepayment rates, probability of default, loss severity and yield
CDOs (5)	2.4	180	(20)	1.0	120	(80)	Implied collateral valuation, defaults rates, housing prices, correlation
CLOs (6)	2.1	180	(50)	0.8	80	(50)	Credit spreads, recovery rates, correlation
Other ABS	1.4	150	(90)	0.9	120	(40)	Credit spreads
Corporate	0.4	30	(30)	0.6	50	(10)	Credit spreads
Banks and building societies	0.3	50	(30)	0.2	10	(30)	Credit spreads
	7.3	700	(300)	4.0	440	(230)	
Equity shares	0.6	110	(120)	0.8	120	(110)	Fund valuation
Derivatives							
Credit - APS	0.6	860	(940)	1.4	1,370	(1,540)	Credit spreads, correlation, expected losses, discount rate recoveries, loss credits
Credit - other	3.0	300	(140)	2.6	360	(350)	Counterparty credit risk, correlation, volatility
Other	1.9	150	(140)	1.5	80	(90)	Volatility, correlation, dividends
	5.5	1,310	(1,220)	5.5	1,810	(1,980)	
Total assets	14.0	2,190	(1,700)	10.8	2,410	(2,330)	
Total assets - 2008				16.6	1,230	(1,310)	
Liabilities							
Debt securities in issue	0.2	30	(40)	0.6	—	—	Proprietary model; correlation, volatility
Derivatives							
Credit - other	0.3	40	(80)	0.7	20	(80)	Proprietary CVA model; industry option models, correlation model; Correlation, volatility
Credit - APS (7)	—	—	—	0.2	20	(10)	Proprietary model; expected losses, credit spreads
Other	1.1	60	(100)	0.7	30	(30)	Proprietary model; volatility, correlation
	1.4	120	(160)	1.6	70	(120)	
Other portfolios	1.0	80	(130)	0.3	30	(10)	Proprietary model; credit spreads, correlation
Total	2.6	210	(350)	2.5	100	(130)	
Total - 2008				4.2	250	(270)	

Notes:

- (1) Level 1: valued using unadjusted quoted prices in active markets, for identical financial instruments. Examples include G10 government securities, listed equity shares, certain exchange-traded derivatives and certain US agency securities.

Level 2: valued using techniques based significantly on observable market data. Instruments in this category are value using;

- (a) quoted prices for similar instruments or identical instruments in markets which are not considered to be active; or
 (b) valuation techniques where all the inputs that have a significant effect on the valuations are directly or indirectly based on observable market data.

The type of instruments that trade in markets that are not considered to be active, but are based on quoted market prices, broker dealer quotations, or alternative pricing sources with reasonable levels of price transparency and those instruments valued using techniques includes non-G10 government securities, most government agency securities, investment-grade corporate bonds, certain mortgage products, most 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.

Level 3: Instruments in this category have been valued using a valuation technique where at least one input which could have a significant effect on the instrument's valuation, is not based on observable market data. Where inputs can be observed from market data without undue cost and effort, the observed input is used. Otherwise, the Group determines a reasonable level for the input. Financial instruments primarily include cash instruments which trade infrequently, certain syndicated and 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.

- (2) Sensitivity represents the favourable and unfavourable effect respectively on the income statement or the statement of comprehensive income due to reasonably possible changes to valuations using reasonably possible alternative inputs to the Group's valuation techniques or models. Totals for sensitivities are not indicative of the total potential effect on the income statement or the statement of comprehensive income.
- (3) Comprise subordinated liabilities.
- (4) Mortgage-backed securities.
- (5) Collateralised debt obligations.
- (6) Collateralised loan obligations.
- (7) Asset Protection Scheme, reflecting arrangements with fellow subsidiary.
- (8) Available-for-sale.

The level 3 sensitivities above are calculated at a trade or low level portfolio basis. They are not calculated on an overall portfolio basis and therefore do not reflect the likely overall potential uncertainty on the whole portfolio. The figures are aggregated and do not reflect the correlated nature of some of the sensitivities. In particular, for some of the portfolios the sensitivities may be negatively correlated where a downwards movement in one asset would produce an upwards movement in another, but due to the additive presentation of the above figures this correlation cannot be observed. For example, with assets in the APS scheme, the downwards sensitivity on the underlying asset would be materially offset by the consequent upward movement of the APS derivative, so whilst the net sensitivity of the two positions may be lower, it would be shown with the gross upside and downside sensitivity of the two assets inflating the overall sensitivity figures in the above table. The actual potential downside sensitivity of the total portfolio may be less than the non-correlated sum of the additive figures as shown in the above table.

11 Financial instruments - valuation *continued*

Judgmental issues

The diverse range of products traded by the Group results in a wide range of instruments that are classified into the three level hierarchy. Whilst the majority of these instruments naturally fall into a particular level, for some products an element of judgment is required. The majority of the Group's financial instruments carried at fair value are classified as level 2: inputs are observable either directly (i.e. as a price) or indirectly (i.e. derived from prices).

Active and inactive markets

A key input in the decision making process for the allocation of assets to a particular level is liquidity. In general, the degree of valuation uncertainty depends on the degree of liquidity of an input. For example, a derivative can be placed into level 2 or level 3 dependent upon its liquidity.

Where markets are liquid or very liquid, little judgment is required. However, when the information regarding the liquidity in a particular market is not clear, a judgment may need to be made. This can be made more difficult as assessing the liquidity of a market may not always be straightforward. For an equity traded on an exchange, daily volumes of trading can be seen, but for an over-the-counter (OTC) derivative assessing the liquidity of the market with no central exchange can be more difficult.

A key related issue is where a market moves from liquid to illiquid or vice versa. Where this change is considered to be temporary, the classification is not changed. For example, if there is little market trading in a product on a reporting date but at the previous reporting date and during the intervening period the market has been considered to be liquid, the instrument will continue to be classified in the same level in the hierarchy. This is to provide consistency so that transfers between levels are driven by genuine changes in market liquidity and do not reflect short term or seasonal effects.

Interaction with the IPV process

The determination of an instrument's level cannot be made at a global product level as a single product type can be in more than one level. For example, a single name corporate credit default swap could be in level 2 or level 3 depending on whether the reference counterparty is liquid or illiquid.

As part of the Group's IPV process, data is gathered at a trade level from market trading activity, trading systems, pricing services, consensus pricing providers, brokers and research material amongst other sources. The breadth and detail of this data allows a good assessment to be made of liquidity and pricing uncertainty, which assists with the process of allocation to an appropriate level. Where suitable independent pricing information is not readily available the instrument will be considered to be level 3.

Modelled products

For modelled products the market convention is to quote these trades through the model inputs or parameters as opposed to a cash price equivalent. A mark-to-market is derived from the use of the independent market inputs calculated using the Group's model.

The decision to classify a modelled asset as level 2 or 3 will be dependent upon the product/model combination, the currency, the maturity, the observability of input parameters and other factors. All these need to be assessed to classify the asset.

An assessment is made of each input into a model. There may be multiple inputs into a model and each is assessed in turn for observability and quality. If an input fails the observability or quality tests then the instrument is considered to be in level 3 unless the input can be shown to have an insignificant effect on the overall valuation of the product.

The majority of derivative instruments are classified as level 2 as they are vanilla products valued using observable inputs. The valuation uncertainty on these is considered to be low and both input and output testing may be available. Examples of these products would be vanilla interest rate swaps, foreign exchange swaps and liquid single name credit derivatives.

Non-modelled products

Non-modelled products are generally quoted on a price basis and can therefore be considered for each of the 3 levels. This is determined by the liquidity and valuation uncertainty of the instruments which is in turn measured from the availability of independent data used by the IPV process.

The availability and quality of independent pricing information is considered during the classification process. An assessment is made regarding the quality of the independent information. For example where consensus prices are used for non-modelled products, a key assessment of the quality of a price is the depth of the number of prices used to provide the consensus price. If the depth of contributors falls below a set hurdle rate, the instrument is considered to be level 3. This hurdle rate is consistent with the rate used in the IPV process to determine whether or not the data is of sufficient quality to adjust the instrument's valuations. However where an instrument is generally considered to be illiquid, but regular quotes from market participants exist, these instruments may be classified as level 2 depending on frequency of quotes, other available pricing and whether the quotes are used as part of the IPV process or not.

For some instruments with a wide number of available price sources, there may be differing quality of available information and there may be a wide range of prices from different sources. In these situations an assessment is made as to which source is the highest quality and this will be used to determine the classification of the asset. For example, a tradable quote would be considered a better source than a consensus price.

Instruments that cross levels

Some instruments will predominantly be in one level or the other, but others may cross between levels. For example, a cross currency swap may be between very liquid currency pairs where pricing is readily observed in the market and will therefore be classified as level 2. The cross currency swap may also be between two illiquid currency pairs in which case the swap would be placed into level 3. Defining the difference between liquid and illiquid may be based upon the number of consensus providers the consensus price is made up from and whether the consensus price can be supplemented by other sources.

Certain portfolios in level 2 contain instruments whose fair values incorporate the judgements discussed above. These include a portfolio of ABS in Non-Core of £5.7 billion that had more than average level of valuation uncertainty with a range of £5.6 billion to £5.9 billion using alternative valuation assumptions.

Level 3 portfolio and sensitivity methodologies

For each of the portfolio categories shown in the tables above, there follows below 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 are valued using an industry standard model and the inputs, where possible, are corroborated using observable market data.

11 Financial instruments - valuation continued

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 classified as 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 purchased credit protection over a portfolio of specified assets and exposures (covered assets) from HMT. 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 was paid on 31 December 2010. Quarterly premiums of £125 million will be payable from 31 December 2011 and subsequently 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 within income from trading activities. There is no change in the recognition and measurement of the covered assets as a result of the APS.

The Bank has also entered into two agreements with RBS N.V., a fellow subsidiary, under which it has sold credit protection over the exposures held by 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 'tranching' protection. The model being used to value the APS - a 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 tranching 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 inputs in relation to each individual asset: notional, maturity, probability of default and expected recovery rate given default. Other key inputs include: the correlation between the underlying assets; the range of possible recovery rates on the underlying assets ("alpha"); the size of the first loss; and the level of expected losses on covered assets that have been sold, that can be treated as losses for the purpose of the APS ("loss credits").

During 2010, refinements were made to the treatment of derivative trades in the valuation model. This followed a change in the nature of protection provided in relation to certain structured credit trades involving mainly asset backed securities and associated bought protection credit derivatives: the risk of losses arising on the derivative trades due to counterparty risk was replaced by the risk of incurring losses on the underlying asset backed securities that are not recovered through the derivative trades. The valuation refinements were made to accurately reflect the impact of this change and ensure a consistent treatment across all derivative trades.

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. In these cases, this important input is determined from information available for similar entities by geography and rating. The approach for doing this was refined during the year in order to accurately reflect both changes in market conditions and the profile of the portfolio of covered assets.

As the inputs into the valuation model are not all observable the APS derivative is a level 3 asset. The fair value of the credit protection at 31 December 2010 was £0.55 billion (2009 - £1.40 billion).

The Group has used the following reasonably possible alternative assumptions in relation to those inputs that could have a significant effect on the valuation of the APS:

Correlation: +/- 10%

The correlation uncertainty relates to both the nature of the underlying portfolio and the seniority of protection. The +/- 10% correlation range looks reasonable in light of market observable correlations of similar levels of protection seniority, for portfolios of investment grade and high yield assets.

Range of possible recovery rates on underlying assets (alpha): +/- 10%

The level of alpha used in the valuation of the APS is in line with that used to value tranches traded by the exotic credit desk and assumes that the underlying assets have a wide range of potential recovery rates. As the APS protects a wider range of asset classes than is generally referenced by exotic credit trades, there is uncertainty in relation to this approach. A comparison of actual recoveries to expected recoveries supports the approach adopted and, in light of this, only changes of +/- 10% in the assumed width of this range are considered reasonable.

Credit spreads: +/- 10%

The credit spread uncertainty relates to determining the probability of default for assets where there is no such observable data in the market. An analysis of the impact on credit spreads of small changes in the ratings assumptions in key geographic regions indicated that overall credit spread movements in the +/- 10% range look reasonable.

Discount curve: +/- 1%

Due to the long-dated contractual maturity of the APS, and the requirement to pay fixed levels of premiums each year, the valuation is sensitive to long-term interest rates. Valuation uncertainty arises due to the illiquidity of such interest rates. An interest rate range of +/- 1% is considered reasonable.

Loss credits: +/- 10%

The level of expected losses on covered assets that have been sold that can be treated as losses for the purpose of the APS are assessed by the Asset Protection Agency. For disposals made by the Group where this assessment has not been completed, the Group makes an estimate of the likely assessment for the purpose of valuing of the APS. A range of +/- 10% in the level of assessment is considered reasonable.

Using the above reasonably possible alternative assumptions, the fair value of the APS derivative could be higher by approximately £860 million or lower by approximately £940 million as detailed in the table below.

Sensitivity	Favourable £m	Unfavourable £m
Correlation +/- 10%	300	300
Recover alpha +/- 10%	250	300
Spreads +/- 10%	125	100
Discount curve +/- 1%	175	230
Loss credit +/- 10%	10	10
Total	860	940

Individual sensitivities above have been aggregated and do not reflect the correlated effect of some of the assumptions as related sensitivities.

Additionally the credit derivative (liability) with RBS N.V. had a value of nil (2009 - £0.2 billion).

11 Financial instruments - valuation continued

Credit derivatives - other

The Group's other credit derivatives include vanilla and bespoke portfolio tranches, gap risk products and certain other unique trades.

Valuation of single name credit derivatives is carried out using industry standard models. Where single name derivatives have been traded and there is a lack of independent data or the quality of the data is weak, these instruments are classified into level 3. These assets will be priced using the Group's standard credit derivative model using a proxy curve based upon a suitable alternative single name curve, a cash based product or a sector based curve. Where the sector based curve is used, the proxy will be chosen taking maturity, rating, seniority, geography and internal credit review on recoveries into account. Sensitivities for these instruments will be based upon the selection of reasonable alternative assumptions which may include adjustments to the credit curve and recovery rate assumptions.

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 by way of 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 and commodity derivatives

Interest rate and commodity 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 and commodity prices. 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.

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

In addition to 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 movement table

2010	At 1 January 2010 £m	Gains/(losses) recognised in the		Transfers in/(out) of level 3 £m	Issuances £m	Purchases £m	Settlements £m	Sales £m	Foreign exchange £m	31 December 2010 £m	At 2010 £m	Gains/ (losses) relating to instruments held at year end £m
		Income statement £m	SOCI £m									
Assets												
FVTPL (1)												
Loans and advances	549	(1)	—	(24)	—	519	(229)	(165)	9	658		(4)
Debt securities	2,684	206	—	1,067	—	1,908	(373)	(2,605)	33	2,920		79
Equity shares	198	74	—	52	—	216	—	(132)	2	410		54
Derivatives	5,509	(1,479)	—	1,996	—	1,034	(152)	(1,475)	51	5,484		(1,479)
FVTPL assets	8,940	(1,200)	—	3,091	—	3,677	(754)	(4,377)	95	9,472		(1,350)
AFS												
Debt securities	1,278	26	512	2,902	—	306	(444)	(274)	29	4,335		10
Equity shares	615	(4)	(39)	(118)	—	18	(2)	(297)	15	188		(4)
AFS assets	1,893	22	473	2,784	—	324	(446)	(571)	44	4,523		6
	10,833	(1,178)	473	5,875	—	4,001	(1,200)	(4,948)	139	13,995		(1,344)
Liabilities												
Deposits	102	—	—	(10)	—	200	(32)	—	2	262		—
Debt securities in issue	592	71	—	—	—	—	(432)	—	—	231		71
Short positions	162	(186)	—	792	6	—	(2)	—	—	772		(179)
Derivatives	1,602	(115)	—	(120)	—	275	(257)	(61)	35	1,359		(86)
Other financial liabilities	1	—	—	—	—	—	—	—	—	1		—
	2,459	(230)	—	662	6	475	(723)	(61)	37	2,625		(194)

Notes on the accounts continued

11 Financial instruments - valuation continued

2009	At 1 January 2009 £m	Gains/(losses) recognised in the Income statement £m	SOCI £m	Transfers in/out of level 3 £m	Reclassification £m	Purchases and issues £m	Sales and settlements £m	Foreign exchange £m	31 December 2009 £m	At 2009 £m	Gains/ (losses) relating to instruments held at year end £m
Assets											
FVTPL (1)											
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	13,625	(3,122)	—	(632)	(1,694)	4,651	(3,427)	(461)	8,940		(483)
AFS											
Debt securities	2,277	(325)	(47)	(255)	—	128	(470)	(30)	1,278		(8)
Equity shares	729	(127)	(13)	62	—	53	(51)	(38)	615		(127)
AFS assets	3,006	(452)	(60)	(193)	—	181	(521)	(68)	1,893		(135)
	16,631	(3,574)	(60)	(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		—
	4,190	(66)	—	(761)	—	396	(1,182)	(118)	2,459		(95)

Note:

(1) Fair value through profit or loss.

There were no significant transfers between level 1 and level 2 during the years 2010 and 2009.

Fair value of financial instruments not carried at fair value

The following table shows the carrying value and the fair value of financial instruments carried on the balance sheet at amortised cost.

	Group						Bank					
	2010 Carrying value £bn	2010 Fair value £bn	2009 Carrying value £bn	2009 Fair value £bn	2008 Carrying value £bn	2008 Fair value £bn	2010 Carrying value £bn	2010 Fair value £bn	2009 Carrying value £bn	2009 Fair value £bn	2008 Carrying value £bn	2008 Fair value £bn
Financial assets												
Cash and balances at central banks	49.8	49.8	27.1	27.1	6.8	6.8	44.9	44.9	21.1	21.1	3.7	3.7
Loans and advances to banks	20.6	20.5	18.8	18.8	18.4	18.4	44.2	43.8	34.9	34.9	35.6	35.7
Loans and advances to customers	455.0	431.0	492.9	465.1	565.6	521.7	290.5	281.2	294.0	277.5	266.7	238.3
Debt securities	6.7	6.0	10.3	9.5	11.8	10.5	78.7	77.4	89.9	90.0	49.0	47.7
Settlement balances	8.7	8.7	9.2	9.2	10.9	10.9	3.5	3.5	4.2	4.2	5.3	5.3
Financial liabilities												
Deposits by banks	31.9	31.8	56.7	56.7	95.0	94.4	143.6	143.6	130.6	130.5	116.1	116.0
Customer accounts	401.1	401.1	395.5	395.0	392.6	392.1	237.5	234.6	236.6	238.5	182.9	182.4
Debt securities in issue	145.9	142.8	158.2	155.4	163.8	158.7	109.3	108.4	115.3	115.6	99.1	98.7
Subordinated liabilities	31.6	30.4	34.1	31.7	39.2	36.1	28.8	27.8	29.9	27.8	33.0	30.5
Settlement balances	8.5	8.5	7.9	7.9	8.8	8.8	3.3	3.3	4.5	4.5	5.5	5.5

The fair value is the amount 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.

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 as follows:

The fair value of financial instruments which are of short maturity (three months or less) approximates their carrying value. This mainly applies 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, adjusting for own credit spreads where appropriate.

12 Financial instruments - maturity analysis**Remaining maturity**

The following tables show the residual maturity of financial instruments, based on contractual date of maturity.

	Group								
	2010			2009			2008		
	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	49,830	8	49,838	27,051	9	27,060	6,804	2	6,806
Loans and advances to banks	84,281	3,224	87,505	65,422	3,019	68,441	77,874	1,513	79,387
Loans and advances to customers	180,573	337,748	518,321	171,907	364,262	536,169	245,607	373,896	619,503
Debt securities	30,031	135,998	166,029	54,042	131,139	185,181	54,909	122,857	177,766
Equity shares	—	2,340	2,340	—	2,405	2,405	—	2,691	2,691
Settlement balances	8,748	—	8,748	9,150	3	9,153	10,869	2	10,871
Derivatives	62,662	366,343	429,005	70,023	376,330	446,353	175,147	762,310	937,457
Liabilities									
Deposits by banks	80,850	4,370	85,220	111,025	5,113	116,138	176,319	5,663	181,982
Customer accounts	457,106	15,219	472,325	436,337	16,965	453,302	438,114	15,015	453,129
Debt securities in issue	80,233	84,429	164,662	96,732	75,681	172,413	122,495	57,447	179,942
Settlement balances and short positions	13,229	36,402	49,631	12,468	31,926	44,394	18,090	27,867	45,957
Derivatives	66,808	354,161	420,969	70,968	353,576	424,544	166,208	742,897	909,105
Subordinated liabilities	1,076	30,947	32,023	1,366	33,351	34,717	1,859	38,092	39,951

	Bank								
	2010			2009			2008		
	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	44,921	—	44,921	21,099	—	21,099	3,714	—	3,714
Loans and advances to banks	91,901	9,064	100,965	66,292	11,073	77,365	84,230	7,487	91,717
Loans and advances to customers	155,713	193,466	349,179	146,843	191,705	338,548	179,790	147,250	327,040
Debt securities	47,383	141,825	189,208	56,574	158,024	214,598	48,458	111,240	159,698
Equity shares	—	1,016	1,016	—	1,025	1,025	—	1,020	1,020
Settlement balances	3,529	—	3,529	4,156	3	4,159	5,334	1	5,335
Derivatives	62,905	369,907	432,812	70,322	380,591	450,913	172,539	765,966	938,505
Liabilities									
Deposits by banks	185,766	12,207	197,973	176,708	11,840	188,548	194,512	6,754	201,266
Customer accounts	178,670	116,688	295,358	202,735	87,057	289,792	200,767	28,499	229,266
Debt securities in issue	61,878	66,195	128,073	72,799	57,015	129,814	83,500	31,649	115,149
Settlement balances and short positions	5,918	23,112	29,030	8,695	19,657	28,352	13,277	16,084	29,361
Derivatives	67,015	357,488	424,503	71,667	358,338	430,005	163,500	747,674	911,174
Subordinated liabilities	585	28,714	29,299	429	30,084	30,513	850	32,848	33,698

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.

2010	Group					
	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	26,306	3,298	1,276	385	612	374
Customers accounts	371,310	17,859	7,459	3,729	2,117	719
Debt securities in issue	82,291	36,368	14,783	12,667	12,190	4,100
Derivatives held for hedging	240	549	919	428	285	28
Subordinated liabilities	13,230	2,741	8,032	5,770	7,404	10,327
Settlement balances and other liabilities	10,309	32	78	67	204	25
	503,686	60,847	32,547	23,046	22,812	15,573
Guarantee and commitments - notional amount						
Guarantees (1, 2)	10,393	—	—	—	—	—
Commitments (3)	234,203	—	—	—	—	—
	244,596	—	—	—	—	—
2009						
Deposits by banks	44,112	7,622	2,959	1,371	135	11
Customer 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

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 £12,479 million (2009 - £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.

12 Financial instruments - maturity analysis *continued*

	Bank					
	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
2010						
Deposits by banks	126,755	7,315	3,808	2,018	1,169	1,023
Customers accounts	221,228	5,648	2,561	2,323	5,605	4,156
Debt securities in issue	53,991	33,292	14,919	12,603	11,844	3,014
Derivatives held for hedging	59	133	332	275	250	21
Subordinated liabilities	13,208	2,220	7,575	5,297	7,186	9,694
Settlement balances and other liabilities	4,437	—	—	—	—	—
	419,678	48,608	29,195	22,516	26,054	17,908
Guarantee and commitments - notional amount						
Guarantees (1, 2)	4,716	—	—	—	—	—
Commitments (3)	144,276	—	—	—	—	—
	148,992	—	—	—	—	—
2009						
Deposits by banks	100,007	13,531	15,069	2,160	556	28
Customer 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						
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

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 £12,479 million (2009 - £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, 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 repayable, 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 along with interest payments after 20 years.

Held-for-trading assets and liabilities -held-for-trading assets and liabilities amounting to £645.6 billion (assets), £587.2 billion (liabilities) (2009 - £638.3 billion assets and £576.0 billion liabilities; 2008 - £1,148.7 billion assets and £1,091.7 billion liabilities) for the Group and £599.7 billion (assets) and £567.4 billion (liabilities) (2009 - £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 table in view of their short term nature.

13 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 2010 £m	2009 £m	2008 £m
At 1 January	5,005	4,654	2,361	12,020	6,655	4,235
Transfers to disposal groups	(72)	—	—	(72)	—	—
Currency translation and other adjustments	(41)	11	25	(5)	(243)	453
Disposals of subsidiaries	(13)	—	—	(13)	—	(178)
Amounts written-off	(1,785)	(2,590)	—	(4,375)	(5,716)	(2,447)
Recoveries of amounts previously written-off	80	280	—	360	307	211
Charged to the income statement	6,203	2,983	113	9,299	11,373	4,555
Unwind of discount	(272)	(172)	—	(444)	(356)	(174)
At 31 December (1)	9,105	5,166	2,499	16,770	12,020	6,655

Note:

(1) Includes £88 million relating to loans and advances to banks (2009 - £90 million; 2008 - £83 million).

	Bank					
	Individually assessed £m	Collectively assessed £m	Latent £m	Total 2010 £m	2009 £m	2008 £m
At 1 January	2,649	1,228	773	4,650	2,475	1,273
Transfers to disposal groups	(72)	—	—	(72)	—	—
Currency translation and other adjustments	(25)	19	—	(6)	(263)	92
Amounts written-off	(2,007)	(530)	—	(2,537)	(2,701)	(794)
Recoveries of amounts previously written-off	57	88	—	145	66	57
Charged to the income statement	3,026	538	(50)	3,514	5,169	1,908
Unwind of discount	(64)	(49)	—	(113)	(96)	(61)
At 31 December (1)	3,564	1,294	723	5,581	4,650	2,475

Note:

(1) Includes £79 million relating to loans and advances to banks (2009 - £80 million; 2008 - £81 million).

	Group		
	2010 £m	2009 £m	2008 £m
Impairment losses charged to the income statement			
Loans and advances to customers	9,299	11,365	4,474
Loans and advances to banks	—	8	81
	9,299	11,373	4,555
Debt securities	71	603	71
Equity shares	30	198	80
	101	801	151
	9,400	12,174	4,706

	Group		
	2010 £m	2009 £m	2008 £m
Gross income not recognised but which would have been recognised under the original terms of the impaired loans			
Domestic	568	613	384
Foreign	530	657	229
	1,098	1,270	613

	Group		
	2010 £m	2009 £m	2008 £m
Interest on impaired loans included in net interest income			
Domestic	214	213	150
Foreign	230	143	24
	444	356	174

Notes on the accounts continued

13 Financial assets - impairments continued

The following tables show an analysis of impaired financial assets.

	2010			Group 2009			2008		
	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)	98	88	10	100	90	10	83	83	—
Loans and advances to customers (2)	33,693	14,183	19,510	27,415	9,569	17,846	13,643	5,244	8,399
	33,791	14,271	19,520	27,515	9,659	17,856	13,726	5,327	8,399

	Group		
	Carrying value 2010 £m	Carrying value 2009 £m	Carrying value 2008 £m
Available-for-sale securities			
Debt securities (1)	566	758	15
Equity shares (1)	43	178	40
Loans and receivables			
Debt securities	107	—	—
	716	936	55

	2010			Bank 2009			2008		
	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)	89	79	10	90	80	10	81	81	—
Loans and advances to customers (3)	12,584	4,779	7,805	11,696	3,797	7,899	5,622	2,035	3,587
	12,673	4,858	7,815	11,786	3,877	7,909	5,703	2,116	3,587

	Bank		
	Carrying value 2010 £m	Carrying value 2009 £m	Carrying value 2008 £m
Available-for-sale securities			
Debt securities (1)	560	754	15
Equity shares (1)	16	153	31
Loans and receivables			
Debt securities	107	—	—
	683	907	46

Notes:

- (1) Impairment provisions individually assessed.
- (2) Impairment provisions individually assessed on balances of £23,679 million (2009 - £18,383 million; 2008 - £6,864 million).
- (3) Impairment provisions individually assessed on balances of £10,205 million (2009 - £9,295 million; 2008 - £3,761 million).

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		
	2010 £m	2009 £m	2008 £m
Residential property	47	52	41
Other property	139	110	—
Cash	127	283	59
Other assets	28	42	30
	341	487	130

	Bank		
	2010 £m	2009 £m	2008 £m
Cash	19	242	30

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
2010	7,179	2,087	1,162	2,839	13,267	944	368	206	1,003	2,521
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

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 £5,380 million for the Group and £3,372 million for the Bank at 31 December 2010 (2009: Group - £2,698 million; Bank - £1,843 million; 2008: Group - £2,637 million; Bank - £2,141 million).

14 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 within approval limits. Residual risk positions are hedged with 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. At 31 December 2010, variable rate financial assets of £41.7 billion for the Group and £36.4 billion for the Bank, and variable rate financial liabilities of £11.4 billion for the Group and £2.6 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.

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. At 31 December 2010, fixed rate financial assets of £16.1 billion for the Group and £7.7 billion for the Bank, and fixed rate financial liabilities of £35.4 billion for the Group and £34.3 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.

The following table shows the notional amounts and fair values of the Group's derivatives:

	2010			Group 2009			2008		
	Notional amount £bn	Assets £m	Liabilities £m	Notional amount £bn	Assets £m	Liabilities £m	Notional amount £bn	Assets £m	Liabilities £m
Exchange rate contracts									
Spot, forwards and futures	2,758	40,830	42,307	1,974	26,766	26,329	2,230	84,165	82,395
Currency swaps	963	28,344	35,584	960	29,310	30,815	848	41,004	44,241
Options purchased	505	14,938	—	436	16,768	—	656	39,025	—
Options written	546	—	13,763	472	—	15,603	702	—	37,024
Interest rate contracts									
Interest rate swaps	29,704	250,108	242,288	30,786	270,305	255,141	36,701	517,731	502,408
Options purchased	2,622	57,475	—	3,225	54,993	—	5,774	99,924	—
Options written	2,738	—	54,280	2,592	—	52,270	3,887	—	97,842
Futures and forwards	4,619	3,061	1,262	6,551	2,090	2,035	9,049	8,530	7,273
Credit derivatives	1,341	28,201	24,446	1,611	42,580	37,816	2,111	131,680	122,198
Equity and commodity contracts	81	6,048	7,039	95	3,541	4,535	534	15,398	15,724
		429,005	420,969		446,353	424,544		937,457	909,105

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.

	2010		Group 2009		2008	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Amounts above include:						
Due from/to holding company	231	1,475	446	1,169	361	1,168
Due from/to fellow subsidiaries	17,238	12,780	31,574	28,175	56,063	53,222

Included above are derivatives held for hedging purposes as follows:

	2010		Group 2009		2008	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Fair value hedging						
Interest rate swaps	1,722	1,412	1,598	1,122	2,047	1,290
Exchange rate contacts	—	—	8	—	—	—
Cash flow hedging						
Exchange rate contracts	—	—	2	—	—	77
Interest rate swaps	2,903	995	1,227	1,646	2,168	2,178
Commodity contracts	—	—	—	—	39	14
Net investment hedging						
Exchange rate contracts	—	13	—	11	—	—

Hedge ineffectiveness recognised in other operating income comprised:

	Group		
	2010 £m	2009 £m	2008 £m
Fair value hedging			
(Losses)/gains on the hedged items attributable to the hedged risk	(120)	628	(949)
Gains/(losses) on the hedging instruments	62	(571)	905
Fair value effectiveness	(58)	57	(44)
Cash flow hedging effectiveness	(37)	14	(16)
	(95)	71	(60)

Notes on the accounts continued

14 Derivatives continued

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.

	Group								Total £m
	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	
2010									
Hedged forecast cash flows expected to occur									
Forecast receivable cash flows	280	254	219	161	120	169	30	—	1,233
Forecast payable cash flows	(47)	(41)	(33)	(30)	(30)	(137)	(176)	(54)	(548)
Hedged forecast cash flows affect on profit or loss									
Forecast receivable cash flows	281	250	214	157	112	161	28	—	1,203
Forecast payable cash flows	(46)	(41)	(33)	(30)	(29)	(137)	(175)	(54)	(545)
2009									
Hedged forecast cash flows expected to occur									
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 on 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									
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 on 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.

	2010			Bank 2009			2008		
	Notional amount £bn	Assets £m	Liabilities £m	Notional amount £bn	Assets £m	Liabilities £m	Notional amount £bn	Assets £m	Liabilities £m
Exchange rate contracts									
Spot, forwards and futures	2,776	41,097	42,530	1,991	26,972	26,687	2,260	85,353	83,417
Currency swaps	982	28,984	37,355	974	29,698	32,996	863	41,783	48,100
Options purchased	505	14,960	—	438	16,806	—	659	39,133	—
Options written	547	—	13,784	474	—	15,629	706	—	37,134
Interest rate contracts									
Interest rate swaps	29,840	252,931	243,498	31,095	273,894	257,731	36,786	522,729	504,692
Options purchased	2,628	57,320	—	3,183	54,859	—	5,750	99,648	—
Options written	2,751	—	54,315	2,555	—	52,342	3,873	—	97,812
Futures and forwards	4,533	3,051	1,265	6,519	2,085	2,038	8,991	8,524	7,270
Credit derivatives	1,343	28,268	24,455	1,618	42,809	37,893	2,358	132,531	123,555
Equity and commodity contracts	80	6,201	7,301	94	3,790	4,689	374	8,804	9,194
		432,812	424,503		450,913	430,005		938,505	911,174

	2010		Bank 2009		2008	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Amounts above include:						
Due from/to holding company	231	1,475	446	1,169	361	1,168
Due from/to fellow subsidiaries	17,224	12,770	31,554	28,170	56,054	52,954
Due from/to subsidiaries	6,630	4,110	7,233	5,912	12,445	11,141

Included in the above are derivatives held for hedging purposes as follows:

	2010		Bank 2009		2008	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Fair value hedging						
Exchange rate contracts	—	1	—	—	—	—
Interest rate contracts	1,559	702	1,458	550	1,850	411
Cash flow hedging						
Exchange rate contracts	—	—	2	—	—	77
Interest rate contracts	2,430	306	1,058	668	1,907	498
Commodity contracts	—	—	—	—	39	—

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.

	Bank								
	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
2010									
Hedged forecast cash flows expected to occur									
Forecast receivable cash flows	248	226	195	145	107	157	30	—	1,108
Forecast payable cash flows	(14)	(14)	(10)	(10)	(10)	(47)	(71)	(19)	(195)
Hedged forecast cash flows affect on profit or loss									
Forecast receivable cash flows	249	222	191	141	99	150	28	—	1,080
Forecast payable cash flows	(14)	(14)	(10)	(10)	(10)	(47)	(71)	(19)	(195)
2009									
Hedged forecast cash flows expected to occur									
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 on 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									
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 on 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)

Notes on the accounts continued

15 Debt securities

2010	Group							Total £m
	UK central and local government £m	US central and local government £m	Other central and local government £m	Banks and building societies £m	Asset backed securities (1) £m	Corporate £m	Other (2) £m	
Held-for-trading	5,092	15,927	40,368	3,753	21,988	4,408	235	91,771
Designated as at fair value through profit or loss	1	—	1	3	119	16	1	141
Available-for-sale	5,651	15,912	14,812	4,464	26,296	286	16	67,437
Loans and receivables	11	—	—	16	6,019	633	1	6,680
	10,755	31,839	55,181	8,236	54,422	5,343	253	166,029

Available-for-sale

Gross unrealised gains	244	109	145	30	998	13	1	1,540
Gross unrealised losses	—	(1)	(1)	(13)	(334)	(23)	(3)	(375)

2009

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)

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 debt securities from the held-for-trading category into the loans and receivables category, and in 2008 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 161 to 164).

Gross gains of £341 million (2009 - £557 million; 2008 - £64 million) and gross losses of £81 million (2009 - £229 million; 2008 - £72 million) were realised by the Group on the sale of available-for-sale securities.

	Bank							Total £m
	UK central and local government £m	US central and local government £m	Other central and local government £m	Banks and building societies £m	Asset backed securities (1) £m	Corporate £m	Other (2) £m	
2010								
Held-for-trading	5,092	2,851	37,140	3,637	4,693	2,083	219	55,715
Designated as at fair value through profit or loss	—	—	—	—	1,011	—	—	1,011
Available-for-sale	5,651	15,474	13,554	4,005	13,503	1,638	—	53,825
Loans and receivables	11	—	—	21	77,531	1,092	2	78,657
	10,754	18,325	50,694	7,663	96,738	4,813	221	189,208
Available-for-sale								
Gross unrealised gains	244	108	130	25	660	12	—	1,179
Gross unrealised losses	—	—	—	(2)	(179)	(12)	—	(193)
2009								
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)

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 debt securities from the held-for-trading category into the loans and receivables category, and in 2008 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 165 and 166).

Notes on the accounts continued

16 Equity shares

	2010			Group 2009			2008		
	Listed £m	Unlisted £m	Total £m	Listed £m	Unlisted £m	Total £m	Listed £m	Unlisted £m	Total £m
Held-for-trading	416	66	482	349	7	356	438	139	577
Designated as at fair value through profit or loss	201	295	496	38	201	239	24	251	275
Available-for-sale	223	1,139	1,362	250	1,560	1,810	57	1,782	1,839
	840	1,500	2,340	637	1,768	2,405	519	2,172	2,691
Available-for-sale									
Gross unrealised gains	46	144	190	73	176	249	4	142	146
Gross unrealised losses	(11)	(34)	(45)	(10)	(57)	(67)	(95)	(59)	(154)

Gross gains of £48 million (2009 - £17 million; 2008 - £188 million) and gross losses of £55 million (2009 - £33 million; 2008 - £6 million) were realised on the sale of available-for-sale equity shares.

Dividend income from available-for-sale equity shares was £176 million (2009 - £50 million; 2008 - £50 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 (2009 - £0.8 billion; 2008 - £0.9 billion), together with a number of individually small shareholdings.

Disposals in the year generated losses of £1.9 million (2009 - £0.6 million; 2008 - nil).

	2010			Bank 2009			2008		
	Listed £m	Unlisted £m	Total £m	Listed £m	Unlisted £m	Total £m	Listed £m	Unlisted £m	Total £m
Held-for-trading	400	65	465	343	6	349	431	32	463
Designated as at fair value through profit or loss	162	35	197	—	7	7	—	28	28
Available-for-sale	187	167	354	218	451	669	17	512	529
	749	267	1,016	561	464	1,025	448	572	1,020
Available-for-sale									
Gross unrealised gains	28	54	82	53	72	125	1	45	46
Gross unrealised losses	(11)	—	(11)	(10)	(13)	(23)	(46)	(19)	(65)

17 Investments in Group undertakings

Investments in Group undertakings are carried at cost less impairment. Movements during the year were as follows:

	Bank		
	2010 £m	2009 £m	2008 £m
At 1 January	29,385	26,814	22,210
Currency translation and other adjustments	364	(224)	898
Additions	—	42	3,943
Additional investments in Group undertakings	3,015	3,724	212
Redemption of investments in Group undertakings	(4,994)	(914)	(349)
Disposals	(78)	—	—
Impairment of investments	(188)	(57)	(100)
At 31 December	27,504	29,385	26,814

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 NatWest. 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, 3)	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 subsidiary undertakings 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.

18 Intangible assets

2010	Group				Total £m
	Goodwill £m	Core deposit intangibles £m	Other purchased intangibles £m	Internally generated software £m	
Cost					
At 1 January 2010	18,455	344	394	3,502	22,695
Currency translation and other adjustments	376	30	14	2	422
Additions	—	—	46	637	683
Disposal of subsidiaries	(539)	(25)	(69)	(63)	(696)
Disposals and write-off of fully amortised assets	—	—	—	(83)	(83)
At 31 December 2010	18,292	349	385	3,995	23,021
Accumulated amortisation and impairment					
At 1 January 2010	7,448	328	251	2,854	10,881
Currency translation and other adjustments	162	13	7	(2)	180
Disposal of subsidiaries	(44)	(23)	(55)	(37)	(159)
Disposals and write-off of fully amortised assets	—	—	—	(68)	(68)
Charge for the year	—	20	45	289	354
Write down of goodwill and other intangible assets	1	—	—	—	1
At 31 December 2010	7,567	338	248	3,036	11,189
Net book value at 31 December 2010	10,725	11	137	959	11,832

Notes on the accounts continued

18 Intangible assets continued

	Group				Total £m
	Goodwill £m	Core deposit intangibles £m	Other purchased intangibles £m	Internally generated software £m	
2009					
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					
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

Notes on the accounts

	Goodwill £m	Bank Internally generated software £m	Total £m
2010			
Cost			
At 1 January 2010	39	1,148	1,187
Currency translation and other adjustments	2	1	3
Additions	—	441	441
Disposal of subsidiaries	—	(51)	(51)
Disposals and write-off of fully amortised assets	—	(68)	(68)
At 31 December 2010	41	1,471	1,512
Accumulated amortisation and impairment			
At 1 January 2010	12	965	977
Disposal of subsidiaries	—	(32)	(32)
Disposals and write-off of fully amortised assets	—	(68)	(68)
Charge for the year	—	192	192
At 31 December 2010	12	1,057	1,069
Net book value at 31 December 2010	29	414	443
2009			
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

18 Intangible assets *continued*
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.

The CGUs of the Group where the goodwill arising is significant, principally on the acquisitions of NatWest and Charter One, are as follows:

	Recoverable amount based on	Goodwill at 30 September 2010 £m	Goodwill at 30 September 2009 £m
UK Retail	Value in use	2,697	2,697
UK Corporate	Value in use	2,693	2,693
Wealth	Value in use	611	611
Global Transaction Services	Value in use	1,464	1,777
US Retail & Commercial	Value in use	2,811	2,761

	Recoverable amount based on	Goodwill prior to write down £m	Write down £m	Goodwill at 31 December 2008 £m
2008				
UK Retail & Commercial Banking	Value in use	6,009	—	6,009
Global Banking & Markets	Value in use	2,225	(2,225)	—
Global Transaction Services	Value in use	1,919	—	1,919
Europe & Middle East Retail & Commercial Banking	Value in use	1,036	(1,036)	—
Asia Retail & Commercial Banking	Value in use	180	(70)	110
US Retail & Commercial Banking	Value in use	7,405	(4,382)	3,023

The analysis of goodwill by operating segment is shown in Note 37.

The recoverable amounts for all CGUs at 30 September 2010 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 3% (2009 - 4%) terminal growth rate and 15.7% (2009 - 14.6%) pre tax discount rate, exceeded the carrying amount by £6.9 billion (2009 - £0.7 billion). A 1% change in the discount rate or the terminal growth rate would change the recoverable amount by approximately £1.5 billion (2009 - £0.9 billion) and £0.9 billion (2009 - £0.5 billion) respectively. In addition, a 5% change in the forecast pre-tax earnings would change the recoverable amount by approximately £0.9 billion (2009 - £0.4 billion).

The recoverable amount UK Corporate, based on a 3% (2009 - 4%) terminal growth rate and a 15.6% (2009 - 15.1%) pre tax discount rate, exceeded its carrying value by £5.3 billion (2009 - £6.1 billion). A 1% change in the discount rate or the terminal growth rate would change the recoverable amount by approximately £1.6 billion (2009 - £1.4 billion) and £0.9 billion (2009 - £0.9 billion) respectively. In addition, a 5% change in the forecast pre-tax earnings would change the recoverable amount by approximately £1.0 billion (2009 - £0.8 billion).

The recoverable amount of Wealth, based on a 3% (2009 - 4%) terminal growth rate and a 12.0% (2009 - 15.3%) pre-tax discount rate, exceeded its carrying value by more than 100% (2009 - 100%) and was insensitive to a reasonably possible change in key assumptions.

The recoverable amount of Global Transaction Services, based on a 3% (2009 - 3%) terminal growth rate and a 12.8% (2009 - 16.7%) pre-tax discount rate, exceeded its carrying value by more than 100% (2009 - 100%) and was insensitive to a reasonably possible change in key assumptions.

The recoverable amount of US Retail & Commercial, based on a 5% (2009 - 5%) terminal growth rate and a 14.9% (2009 - 14.8%) pre-tax discount rate, exceeded its carrying value by £1.6 billion (2009 - £2.1 billion). A 1% change in the discount rate or the terminal growth rate would change the recoverable amount by approximately £1.6 billion (2009 - £1.0 billion) and £0.8 billion (2009 - £0.8 billion) respectively. In addition, a 5% change in the forecast pre-tax earnings would change the recoverable amount by approximately £0.7 billion (2009 - £0.7 billion).

In 2008, the recoverable amounts for all CGUs were based on value in use tests. Goodwill write downs were recorded in Global Banking & Markets, Europe & Middle East Retail & Commercial Banking, Asia Retail & Commercial Banking divisions and US Retail & Commercial.

19 Property, plant and equipment

2010	Group						Total £m
	Investment properties £m	Freehold premises £m	Long leasehold premises £m	Short leasehold premises £m	Computers and other equipment £m	Operating lease assets £m	
<i>Cost or valuation</i>							
At 1 January 2010	4,883	2,678	213	1,634	3,707	9,171	22,286
Currency translation and other adjustments	—	43	2	48	216	249	558
Disposal of subsidiaries	—	(1)	—	(3)	(121)	—	(125)
Reclassifications	—	26	1	(41)	14	—	—
Additions	511	81	5	130	340	1,178	2,245
Expenditure on investment properties	2	—	—	—	—	—	2
Change in fair value of investment properties	(405)	—	—	—	—	—	(405)
Disposals and write-off of fully depreciated assets	(821)	(59)	(6)	(86)	(259)	(1,363)	(2,594)
At 31 December 2010	4,170	2,768	215	1,682	3,897	9,235	21,967
<i>Accumulated impairment, depreciation and amortisation</i>							
At 1 January 2010	—	530	87	606	2,124	1,630	4,977
Currency translation and other adjustments	—	20	2	40	189	27	278
Disposal of subsidiaries	—	—	—	(2)	(74)	—	(76)
Reclassifications	—	1	—	—	(1)	—	—
Write down of property, plant and equipment	—	32	4	—	—	—	36
Disposals and write-off of fully depreciated assets	—	(10)	(2)	(48)	(231)	(435)	(726)
Charge for the year	—	91	11	133	473	627	1,335
At 31 December 2010	—	664	102	729	2,480	1,849	5,824
Net book value at 31 December 2010	4,170	2,104	113	953	1,417	7,386	16,143
<i>2009</i>							
<i>Cost or valuation</i>							
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
<i>Accumulated impairment, depreciation and amortisation</i>							
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

19 Property, plant and equipment *continued*

2008	Group						Total £m
	Investment properties £m	Freehold premises £m	Long leasehold premises £m	Short leasehold premises £m	Computers and other equipment £m	Operating lease assets £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

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 is not necessarily 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 2010 for a significant majority of the Group's investment properties was undertaken with the support of external valuers.

The fair value of investment properties includes £248 million of depreciation since purchase (2009 - £84 million appreciation; 2008 - £172 million appreciation).

Rental income from investment properties was £279 million (2009 - £233 million; 2008 - £257 million). Direct operating expenses of investment properties were £42 million (2009 - £16 million; 2008 - £22 million).

Property, plant and equipment, excluding investment properties, include £298 million (2009 - £213 million; 2008 - £1,132 million) assets in the course of construction.

Freehold and long leasehold properties with a net book value of £2 million (2009 - £5 million; 2008 - nil) were sold subject to operating leases.

2010	Bank					Total £m
	Freehold premises £m	Long leasehold premises £m	Short leasehold premises £m	Computers and other equipment £m	Operating lease assets £m	
Cost or valuation						
At 1 January 2010	1,077	52	758	2,070	91	4,048
Currency translation and other adjustments	1	1	6	5	—	13
Reclassifications	4	—	(15)	11	—	—
Additions	13	1	34	235	11	294
Transfer from fellow subsidiary	2	—	2	7	3	14
Disposals and write-off of fully depreciated assets	(4)	—	(31)	(151)	(105)	(291)
At 31 December 2010	1,093	54	754	2,177	—	4,078
Accumulated impairment, depreciation and amortisation						
At 1 January 2010	187	25	218	1,109	62	1,601
Currency translation and other adjustments	(1)	—	4	4	—	7
Transfer from fellow subsidiary	—	—	—	—	3	3
Disposals and write-off of fully depreciated assets	(1)	—	(22)	(114)	(66)	(203)
Charge for the year	41	2	54	271	1	369
At 31 December 2010	226	27	254	1,270	—	1,777
Net book value at 31 December 2010	867	27	500	907	—	2,301
2009						
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						
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

20 Prepayments, accrued income and other assets

	Group			Bank		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Prepayments	1,054	1,146	768	2,107	2,111	301
Accrued income	963	885	1,189	694	571	858
Deferred expenses	277	143	289	176	33	252
Pension schemes in net surplus	39	28	4	7	9	4
Other assets	3,904	10,463	9,147	1,776	7,264	4,515
	6,237	12,665	11,397	4,760	9,988	5,930

21 Assets and liabilities of disposal groups

	Group		Bank		
	2010 £m	2009 £m	2010 £m	2009 £m	
Assets of disposal groups					
Loans and advances to banks		629	314	273	78
Loans and advances to customers		2,884	306	2,329	43
Debt securities and equity shares		17	56	2	20
Derivatives		5,148	6,361	1,757	2,824
Intangible assets		—	238	—	9
Settlement balances		555	1,579	295	502
Property, plant and equipment		18	92	—	—
Other assets		291	5,257	109	3,674
		9,542	14,203	4,765	7,150
Liabilities of disposal groups					
Deposits by banks		266	560	140	464
Customer accounts		900	1,961	144	1,755
Derivatives		5,042	6,262	1,610	2,966
Settlement balances		907	950	391	—
Other liabilities		393	1,260	51	923
		7,508	10,993	2,336	6,108

To comply with EC State Aid requirements, the RBS Group has agreed to make a series of divestments within four years from December 2009. During 2010, the Group successfully completed the disposal of 80.01% of Global Merchant Services and substantially all of the RBS Sempra Commodities JV. Certain contracts of the RBS Sempra Commodities JV business were sold in risk transfer transactions prior to being novated to the purchaser and they comprise substantially all of its residual assets

and liabilities. RBS Sempra Commodities JV was the only significant divestment that met the criteria for classification as a disposal group at 31 December 2010.

The other assets and liabilities classified as disposal groups include the project finance assets to be sold to the Bank of Tokyo-Mitsubishi UFJ Ltd and certain non-core interests in Europe.

22 Short positions

	Group			Bank		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Debt securities						
- Government	34,437	26,646	31,899	21,268	17,759	19,930
- Other issuers	6,412	9,825	4,521	4,120	6,051	3,145
Equity shares	281	1	752	299	1	752
	41,130	36,472	37,172	25,687	23,811	23,827

Note:

(1) All short positions are classified as held-for-trading.

23 Accruals, deferred income and other liabilities

	Group			Bank		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Notes in circulation	1,793	1,889	1,619	1,094	1,172	1,087
Current tax	561	150	201	755	295	47
Accruals	5,415	5,769	5,870	3,392	3,721	3,826
Deferred income	1,457	1,388	1,564	861	865	1,143
Other liabilities (1)	4,508	7,278	7,431	1,956	3,896	3,515
	13,734	16,474	16,685	8,058	9,949	9,618

Note:

(1) Other liabilities include £18 million (2009 - £10 million; 2008 - £1 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 2010	492	364
Currency translation and other movements	(42)	(36)
Disposal of subsidiaries	(2)	—
Transfer to disposal groups	(12)	(12)
Charge to income statement	427	358
Releases to income statement	(72)	(61)
Provisions utilised	(207)	(156)
At 31 December 2010	584	457

Note:

(1) The table above includes property provisions and other provisions arising in the normal course of business.

24 Deferred tax

	Group			Bank		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Deferred tax liability	1,422	1,187	2,483	—	—	—
Deferred tax asset	(1,790)	(2,228)	(2,833)	(794)	(1,728)	(1,323)
Net deferred tax asset	(368)	(1,041)	(350)	(794)	(1,728)	(1,323)

	Group											
	Pension £m	Accelerated capital allowances £m	Provisions £m	Deferred gains £m	IFRS transition £m	Fair value of financial instruments £m	Available- for-sale financial assets £m	Intangibles £m	Cash flow hedging £m	Tax losses carried forward £m	Other £m	Total £m
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 1 January 2010	(686)	2,818	(1,436)	115	(370)	(254)	(97)	44	275	(1,466)	16	(1,041)
Transfers to disposal groups	—	(120)	—	—	—	1	—	—	—	—	—	(119)
Charge/(credit) to income statement	94	(95)	94	(25)	76	263	77	45	(102)	162	(132)	457
Charge/(credit) to equity directly	73	—	—	(2)	—	—	102	—	(203)	397	(6)	361
Disposals	—	—	—	—	—	(1)	—	—	—	—	(18)	(19)
Other	2	49	(41)	—	—	(7)	(6)	2	(2)	(7)	3	(7)
At 31 December 2010	(517)	2,652	(1,383)	88	(294)	2	76	91	(32)	(914)	(137)	(368)

	Bank										
	Pension £m	Accelerated capital allowances £m	Provisions £m	Deferred gains £m	IFRS transition £m	Available- for-sale financial assets £m	Cash flow hedging £m	Tax losses carried forward £m	Other £m	Total £m	
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 1 January 2010	(7)	(230)	(472)	49	(155)	—	231	(1,135)	(9)	(1,728)	
Charge/(credit) to income statement	—	37	(48)	—	30	—	5	594	(13)	605	
(Credit)/charge to equity directly	—	—	—	(5)	—	—	(59)	397	(4)	329	
At 31 December 2010	(7)	(193)	(520)	44	(125)	—	177	(144)	(26)	(794)	

Notes:

- 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 18) indicate it is probable that sufficient future taxable income will be available against which to offset these recognised deferred tax assets within eight years. In jurisdictions where doubt exists over the availability of future taxable profits, deferred tax assets of £298 million (2009 - £26 million; 2008 - £29 million) have not been recognised in respect of tax losses carried forward of £2,422 million (2009 - £100 million; 2008 - £108 million). Of these losses, £227 million will expire after five years. The balance of tax losses carried forward has no time limit.
- Deferred tax liabilities of £279 million (2009 - £279 million; 2008 - £844 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 tax. No tax is expected to arise in the foreseeable future in respect of held-over gains. Changes to UK tax legislation largely exempts from UK tax, overseas dividends received on or after 1 July 2009.

25 Subordinated liabilities

	Group			Bank		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Dated loan capital	21,645	22,067	20,594	20,115	19,688	17,135
Undated loan capital	7,039	9,427	15,208	6,157	7,940	12,774
Preference shares	3,339	3,223	4,149	3,027	2,885	3,789
	32,023	34,717	39,951	29,299	30,513	33,698

In May 2010, the Group redeemed certain subordinated debt securities in exchange for cash or senior debt. 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 £502 million were credited to profit or loss.

A similar series of exchange and tender offers completed in April 2009 and resulted in a gain of £2,694 million.

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 RBS Holdings N.V. Group, which are subject to different restrictions) 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 30 April 2010 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.

Notes on the accounts continued

25 Subordinated liabilities continued

The following tables analyse the remaining contractual maturity of subordinated liabilities by (1) the final redemption date; and (2) the next call date.

2010 - final redemption	Group						Total £m
	2011 £m	2012 £m	2013-2015 £m	2016-2020 £m	Thereafter £m	Perpetual £m	
Sterling	78	—	817	5,063	361	2,290	8,609
US dollars	263	262	2,245	2,582	—	6,043	11,395
Euro	708	—	2,081	3,556	1,362	1,607	9,314
Other	27	—	1,612	728	—	338	2,705
Total	1,076	262	6,755	11,929	1,723	10,278	32,023

2010 - call date	Group							Total £m
	Currently £m	2011 £m	2012 £m	2013-2015 £m	2016-2020 £m	Thereafter £m	Perpetual £m	
Sterling	13	97	55	1,027	6,717	530	170	8,609
US dollars	2,379	2,016	1,228	3,721	328	1,240	483	11,395
Euro	613	689	1,521	2,387	3,631	424	49	9,314
Other	672	11	728	956	338	—	—	2,705
Total	3,677	2,813	3,532	8,091	11,014	2,194	702	32,023

2009 - final redemption	Group						Total £m
	2010 £m	2011 £m	2012-2014 £m	2015-2019 £m	Thereafter £m	Perpetual £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

2009 - call date	Group							Total £m
	Currently £m	2010 £m	2011 £m	2012-2014 £m	2015-2019 £m	Thereafter £m	Perpetual £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

2008 - final redemption	Group						Total £m
	2009 £m	2010 £m	2011-2013 £m	2014-2018 £m	Thereafter £m	Perpetual £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

2008 - call date	Group							Total £m
	Currently £m	2009 £m	2010 £m	2011-2013 £m	2014-2018 £m	Thereafter £m	Perpetual £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

Notes on the accounts

2010 - final redemption	Bank						Total £m
	2011 £m	2012 £m	2013-2015 £m	2016-2020 £m	Thereafter £m	Perpetual £m	
Sterling	46	—	454	5,000	—	1,938	7,438
US dollars	257	—	2,245	2,582	1,497	3,925	10,506
Euro	264	—	2,081	3,556	2,452	306	8,659
Other	18	—	1,612	728	—	338	2,696
Total	585	—	6,392	11,866	3,949	6,507	29,299

2010 - call date	Currently £m	Bank						Total £m
		2011 £m	2012 £m	2013-2015 £m	2016-2020 £m	Thereafter £m	Perpetual £m	
Sterling	2	76	55	514	6,717	74	—	7,438
US dollars	1,755	2,013	966	3,721	328	1,240	483	10,506
Euro	450	246	1,521	2,387	3,631	424	—	8,659
Other	663	11	728	956	338	—	—	2,696
Total	2,870	2,346	3,270	7,578	11,014	1,738	483	29,299

2009 - final redemption	Bank						Total £m
	2010 £m	2011 £m	2012-2014 £m	2015-2019 £m	Thereafter £m	Perpetual £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	Currently £m	Bank						Total £m
		2010 £m	2011 £m	2012-2014 £m	2015-2019 £m	Thereafter £m	Perpetual £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						Total £m
	2009 £m	2010 £m	2011-2013 £m	2014-2018 £m	Thereafter £m	Perpetual £m	
Sterling	132	—	167	298	—	6,935	7,532
US dollar	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	Currently £m	Bank						Total £m
		2009 £m	2010 £m	2011-2013 £m	2014-2018 £m	Thereafter £m	Perpetual £m	
Sterling	—	132	397	964	3,135	2,904	—	7,532
US dollar	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

Notes on the accounts *continued*

25 Subordinated liabilities *continued*

Dated loan capital	2010 £m	2009 £m	2008 £m
<i>The Bank</i>			
€300 million 4.875% subordinated notes 2009	—	—	298
€1,000 million 6% subordinated notes 2013	989	1,014	1,083
US\$50 million floating rate subordinated notes 2013	38	36	36
€500 million 6% subordinated notes 2013	439	452	487
£150 million 10.5% subordinated bonds 2013 (1)	177	177	180
US\$1,250 million floating rate subordinated notes 2014	—	—	862
AUD590 million 6% subordinated notes 2014 (callable January 2011)	391	330	281
AUD410 million floating rate subordinated notes 2014 (callable January 2011)	272	229	195
CAD700 million 4.25% subordinated notes 2015	452	419	409
£250 million 9.625% subordinated bonds 2015	303	301	311
US\$750 million floating rate subordinated notes 2015 (callable September 2011)	483	462	513
€750 million floating rate subordinated notes 2015	725	741	783
CHF400 million 2.375% subordinated notes 2015	287	244	257
CHF100 million 2.375% subordinated notes 2015	83	69	72
CHF200 million 2.375% subordinated notes 2015	136	117	125
US\$500 million floating rate subordinated notes 2016 (callable October 2011)	322	308	346
US\$1,500 million floating rate subordinated notes 2016 (callable April 2011)	967	926	1,038
€500 million 4.5% subordinated notes 2016 (callable January 2011)	450	476	511
CHF200 million 2.75% subordinated notes 2017 (callable December 2012)	138	120	129
€100 million floating rate subordinated notes 2017	86	89	97
€500 million floating rate subordinated notes 2017 (callable June 2012)	432	445	482
€750 million 4.35% subordinated notes 2017	721	728	770
AUD450 million 6.5% subordinated notes 2017 (callable February 2012)	302	255	217
AUD450 million floating rate subordinated notes 2017 (callable February 2012)	295	250	214
US\$1,500 million floating rate subordinated callable step-up notes 2017 (callable August 2012)	966	925	1,029
€2,000 million 6.93% subordinated notes 2018	1,999	2,017	2,136
US\$125.6 million floating rate subordinated notes 2020	81	78	87
€1,000 million 4.625% subordinated notes 2021 (callable September 2016)	949	962	1,019
€300 million CMS linked floating rate subordinated notes 2022	280	292	303
€144.4 million floating rate subordinated notes 2022	153	143	152
<i>Due to the holding company</i>			
US\$400 million 6.4% subordinated notes 2009	—	—	278
US\$300 million 6.375% subordinated notes 2011 (redeemed February 2011) (2)	199	201	231
US\$750 million 5% subordinated notes 2013 (2)	533	504	581
US\$750 million 5% subordinated notes 2014 (2)	562	522	617
US\$250 million 5% subordinated notes 2014 (2)	158	151	168
US\$675 million 5.05% subordinated notes 2015 (2)	493	469	551
US\$350 million 4.7% subordinated notes 2018 (2)	252	232	287
£5,000 million 4.5% subordinated notes 2019 (2)	5,002	5,004	—
	20,115	19,688	17,135
<i>National Westminster Bank Plc</i>			
US\$1,000 million 7.375% subordinated notes 2009	—	—	697
€600 million 6% subordinated notes 2010 (redeemed January 2010)	—	564	623
€500 million 5.125% subordinated notes 2011	442	455	488
£300 million 7.875% subordinated notes 2015	370	365	379
£300 million 6.5% subordinated notes 2021	367	351	376
<i>Charter One Financial, Inc.</i>			
US\$400 million 6.375% subordinated notes 2012	265	255	287

Dated loan capital	2010 £m	2009 £m	2008 £m
<i>RBS Holdings USA Inc.</i>			
US\$170 million subordinated loan capital floating rate notes 2009	—	—	116
US\$100 million 5.575% senior subordinated revolving credit 2009	—	—	69
US\$500 million subordinated loan capital floating rate notes 2010 (redeemed December 2010)	—	311	342
<i>First Active plc</i>			
£60 million 6.375% subordinated bonds 2018 (callable April 2013)	66	66	66
<u>Non-controlling interests subordinated issues</u>	20	12	16
	21,645	22,067	20,594

Notes:

- (1) Unconditionally guaranteed by The Royal Bank of Scotland Group plc.
- (2) On-lent to The Royal Bank of Scotland Group plc on a subordinated basis.
- (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.

Notes on the accounts *continued*

25 Subordinated liabilities *continued*

Undated loan capital	2010 £m	2009 £m	2008 £m
<i>The Bank</i>			
£31 million (2009 - £96 million; 2008 - £175 million) 7.375% undated subordinated notes (callable August 2011) ^(1,2)	31	101	190
£51 million (2009 - £117 million; 2008 - £350 million) 6.25% undated subordinated notes (callable December 2012) ^(1,2)	55	126	380
£56 million (2009 - £138 million; 2008 - £500 million) 6% undated subordinated notes (callable September 2014) ^(1,2)	61	143	565
€176 million (2009 - €197 million; 2008 - €500 million) 5.125% undated subordinated notes callable July 2014) ^(1,2)	166	194	516
€170 million (2009 - €243 million; 2008 - €1,000 million) floating rate undated subordinated notes (callable July 2014) ^(1,2)	145	214	966
£54 million (2009 - £178 million; 2008 - £500 million) 5.125% undated subordinated notes (callable March 2016) ^(1,2)	58	189	556
£200 million 5.125% subordinated upper tier 2 notes (redeemed May 2010)	—	210	210
£35 million (2009 - £260 million; 2008 - £600 million) 5.5% undated subordinated notes (callable December 2019) ^(1,2)	35	272	677
£21 million (2009 - £174 million; 2008 - £500 million) 6.2% undated subordinated notes (callable March 2022) ^(1,2)	43	206	614
£103 million (2009 - £145 million; 2008 - £200 million) 9.5% undated subordinated bonds (callable August 2018) ^(1,2,5)	130	176	253
£400 million 5.625% subordinated upper tier 2 notes	—	—	397
£22 million (2009 - £83 million; 2008 - £300 million) 5.625% undated subordinated notes (callable September 2026) ^(1,2)	21	90	431
£19 million (2009 - £201 million; 2008 - £500 million) 5.625% undated subordinated notes (callable June 2032) ^(1,2)	20	199	508
£1 million (2009 - £190 million; 2008 - £400 million) 5% undated subordinated notes (callable March 2011) ^(1,2)	2	197	424
JPY25 billion 2.605% undated subordinated notes (redeemed May 2010)	—	173	217
CAD474 million (2009 and 2008 - CAD700 million) 5.37% fixed rate undated subordinated notes (callable May 2016) ⁽²⁾	340	452	464
<i>Due to the holding company</i>			
US\$350 million undated floating rate primary capital notes (callable on any interest payment date) ⁽³⁾	225	216	240
€1,250 million 6.467% perpetual regulatory tier one securities (callable June 2012) ⁽³⁾	1,125	1,174	1,325
US\$1,200 million 7.648% perpetual regulatory tier one securities (callable September 2031) ^(3,4)	783	748	831
£1,500 million floating rate perpetual subordinated notes ⁽³⁾	1,500	1,500	1,500
US\$600 million floating rate perpetual subordinated notes ⁽³⁾	386	370	412
US\$1,600 million floating rate perpetual subordinated notes ⁽³⁾	1,031	990	1,098
	6,157	7,940	12,774
<i>National Westminster Bank Plc</i>			
US\$193 million (2009 - US\$332 million; 2008 - US\$500 million) primary capital floating rate notes, Series A (callable on any interest payment date) ^(1,2)	124	205	343
US\$229 million (2009 - US\$293 million; 2008 - US\$500 million) primary capital floating rate notes, Series B (callable on any interest payment date) ^(1,2)	148	182	347
US\$285 million (2009 - US\$312 million; 2008 - US\$500 million) primary capital floating rate notes, Series C (callable on any interest payment date) ^(1,2)	184	192	346
€178 million (2009 and 2008 - €400 million) 6.625% fixed/floating rate undated subordinated notes (callable on any interest payment date) ⁽²⁾	154	359	388
€10 million (2009 and 2008 - €100 million) floating rate undated step-up notes (callable on any interest payment date) ⁽²⁾	9	90	97
£87 million (2009 - £162 million; 2008 - £325 million) floating undated subordinated step-up notes (callable January 2015) ^(1,2)	89	174	363
£53 million (2009 - £127 million; 2008 - £200 million) 7.125% undated subordinated step-up notes (callable October 2022) ^(1,2)	54	127	201
£35 million (2009 - £55 million; 2008 - £200 million) 11.5% undated subordinated notes (callable December 2022) ^(1,2,6)	42	79	269

Undated loan capital	2010 £m	2009 £m	2008 £m
<i>First Active plc</i>			
£20 million 11.75% perpetual tier two capital	26	26	26
€38 million 11.375% perpetual tier two capital	50	51	52
£1.3 million floating rate perpetual tier two capital	2	2	2
	7,039	9,427	15,208

Notes:

- (1) Partially repurchased following completion of the exchange and tender offers in April 2009.
- (2) Partially repurchased following completion of the exchange and tender offers in May 2010.
- (3) On-lent to The Royal Bank of Scotland plc on a subordinated basis.
- (4) The company can satisfy interest payment obligations by issuing sufficient ordinary shares to appointed Trustees to enable them, on selling these shares, to settle the interest payment.
- (5) Guaranteed by the company.
- (6) 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.
- (7) 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.
- (8) 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.
- (9) Interest on all floating rate subordinated notes is calculated by reference to market rates.

Preference shares	2010 £m	2009 £m	2008 £m
<i>The Bank</i>			
Non-cumulative preference shares of US\$0.01 (1)			
Series F US\$200 million 7.65% (redeemable at option of issuer)	129	123	137
Series H US\$300 million 7.25% (redeemable at option of issuer)	193	185	205
Series L US\$750 million 6.8% (perpetual callable March 2008)	483	462	514
Series M US\$850 million 4.709% (callable July 2013)	542	522	640
Series N US\$650 million 6.425% (callable January 2034)	472	439	677
Series R US\$850 million 5.75% (redeemable at option of issuer)	548	524	582
Series 1 US\$1,000 million 9.118% (redeemable at option of issuer)	660	630	698
Non-cumulative preference shares of £1			
Series 1 £200 million 7.387%	—	—	211
£125 million 7.25%	—	—	125
	3,027	2,885	3,789
<i>National Westminster Bank Plc</i>			
Non-cumulative preference shares of £1			
Series A £140 million 9% (non-redeemable)	144	145	145
Non-cumulative preference shares of US\$25			
Series C US\$246 million 7.7628% (2009 and 2008 - US\$300 million) (2,3)	168	193	215
	3,339	3,223	4,149

Notes:

- (1) Issued by the Bank to the holding company on terms which, in general, mirror the original issues by the holding company.
- (2) Partially repurchased following completion of the exchange and tender offers in May 2010.
- (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 par.

26 Non-controlling interests

	Group		
	2010 £m	2009 £m	2008 £m
At 1 January	1,146	1,292	152
Currency translation and other adjustments	67	(126)	344
Profit attributable to non-controlling interests	29	235	208
Dividends paid	(154)	(261)	(84)
Equity raised	58	9	812
Equity withdrawn and disposals	(549)	(3)	(140)
At 31 December	597	1,146	1,292

27 Share capital and reserves

	Allotted, called up and fully paid			Authorised (1)	
	2010 £m	2009 £m	2008 £m	2009 m	2008 m
Ordinary shares of £1	6,609	6,609	6,481	£7,980	£7,980
Non-cumulative preference shares of US\$0.01	—	—	2	\$5	\$5
Non-cumulative preference shares of €0.01	—	—	—	—	—
Perpetual zero coupon preference shares of £1	—	—	—	£100	£100
Non-cumulative preference shares of £1	—	—	126	£2,200	£2,200

	Allotted, called up and fully paid			Authorised (1)	
	2010	2009	2008	2009	2008
Number of shares - millions					
Ordinary shares of £1	6,609	6,609	6,481	7,980	7,980
Non-cumulative preference shares of US\$0.01	59	59	313	549	549
Non-cumulative preference shares of €0.01	1	1	3	66	66
Perpetual zero coupon preference shares of £1	—	—	—	100	100
Non-cumulative preference shares of £1	—	—	126	2,200	2,200

Note:

(1) Prior to the Companies Act 2006, the authorised share capital of UK companies was divided between issued share capital and unissued share capital whose allotment was determined by the Articles of Association of a company and specific authorities granted to directors. Since 28 April 2010 when the company changed its constitution to reflect the Companies Act 2006, there is no authorised share capital.

Ordinary and preference shares

There were no changes in the issued ordinary or preference share capital during the year.

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.

28 Leases

Minimum amounts receivable under non-cancellable leases:

	Finance lease contracts and hire purchase agreements				Operating lease assets:
	Gross amount £m	Unearned finance income £m	Other movements £m	Present value £m	future minimum lease rentals £m
2010					
Receivable:					
Within 1 year	3,559	(309)	(20)	3,230	997
After 1 year but within 5 years	7,833	(795)	(245)	6,793	2,388
After 5 years	7,843	(2,763)	(263)	4,817	998
Total	19,235	(3,867)	(528)	14,840	4,383

2009

Receivable:					
Within 1 year	3,863	(781)	(30)	3,052	763
After 1 year but within 5 years	8,768	(2,076)	(212)	6,480	2,348
After 5 years	11,258	(2,469)	(334)	8,455	947
Total	23,889	(5,326)	(576)	17,987	4,058

2008

Receivable:					
Within 1 year	3,947	(947)	(24)	2,976	897
After 1 year but within 5 years	9,925	(2,369)	(162)	7,394	2,307
After 5 years	12,963	(3,125)	(385)	9,453	1,058
Total	26,835	(6,441)	(571)	19,823	4,262

	Group		
	2010 £m	2009 £m	2008 £m
Nature of operating lease assets on the balance sheet			
Transportation	6,162	6,039	5,883
Cars and light commercial vehicles	1,016	1,249	1,199
Other	208	253	338
	7,386	7,541	7,420
Amounts recognised as income and expense			
Finance leases - contingent rental income	(160)	(139)	(37)
Operating leases - minimum rentals payable	411	435	380
Finance lease contracts and hire purchase agreements			
Accumulated allowance for uncollectable minimum receivables	401	313	213

	Bank		
	2010 £m	2009 £m	2008 £m
Amounts recognised as income and expense			
Operating leases - minimum rentals payable	161	164	164

Notes on the accounts continued

28 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 pages 152 to 154) and operating lease assets (see pages 199 and 200).

	Year in which residual value will be recovered				Total £m
	Within 1 year £m	After 1 year but within 2 years £m	After 2 years but within 5 years £m	After 5 years £m	
2010					
Operating leases					
- transportation	357	457	1,834	2,097	4,745
- cars and light commercial vehicles	503	109	100	9	721
- other	30	20	39	13	102
Finance lease contracts	20	41	131	263	455
Hire purchase agreements	—	3	70	—	73
	910	630	2,174	2,382	6,096
2009					
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.

29 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.

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 page 111) and other asset transfers where substantially all the risks and rewards of the asset have been retained by the Group.

Asset type	2010		Group 2009		2008	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Residential mortgages	75,847	17,881	68,963	15,749	53,528	18,613
Credit card receivables	3,993	34	2,975	1,592	3,004	3,197
Other loans	30,988	974	36,448	1,010	1,679	1,071
Commercial paper conduits	17,766	15,075	19,671	17,888	31,473	30,833
Finance lease receivables	510	510	597	597	1,077	857
	129,104	34,474	128,654	36,836	90,761	54,571

Refer to page 112 for additional analysis on commercial paper conduits.

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. Assets are significantly greater than liabilities, as all notes issued by funding related own assets securitisation SPEs are purchased by Group companies.

Continuing involvement

At 31 December 2010, securitised assets were £2.3 billion (2009 - £3.1 billion; 2008 - £1.1 billion); retained interest £286 million (2009 - £102 million; 2008 - £51 million) subordinated assets £4 million (2009 - £91 million; 2008 - £9 million) and related liabilities £4 million (2009 - £33 million; 2008 - £9 million).

Other collateral given

Group assets pledged against Group liabilities	Group		
	2010 £m	2009 £m	2008 £m
Loans and advances to banks	25,148	18,409	29,706
Loans and advances to customers	44,781	33,276	39,930
Debt securities	4,318	5,875	12,809
	74,247	57,560	82,445

Liabilities secured by Group assets

Deposits by banks	7,684	12,724	11,322
Customer accounts	3,599	4,025	10,907
Debt securities in issue	—	1,237	110
Derivatives	78,989	42,707	78,823
	90,272	60,693	101,162

30 Capital resources

The Group's regulatory capital resources in accordance with Financial Services Authority (FSA) definitions were as follows:

	2010 £m	2009 £m	2008 £m
Composition of regulatory capital			
Tier 1			
Ordinary shareholders' equity	55,589	53,630	36,711
Non-controlling interests	597	1,146	1,292
Adjustment for:			
- goodwill and other intangible assets - continuing businesses	(11,832)	(11,814)	(12,591)
- goodwill and other intangible assets - discontinued businesses	—	(238)	—
- unrealised losses on available-for-sale (AFS) debt securities	(843)	279	1,855
- reserves arising on revaluation of property and unrealised gains on AFS equities	(74)	(184)	(154)
- other regulatory adjustments	(818)	(796)	(56)
Less excess of expected loss over provisions net of tax	(1,998)	(2,560)	(771)
Less securitisation positions	(1,916)	(1,270)	(561)
Less APS first loss	(4,225)	(4,654)	—
Core Tier 1 capital	34,480	33,539	25,725
Preference shares	2,890	2,883	10,896
Innovative Tier 1 securities	3,638	3,542	4,177
Tax on the excess of expected losses over provisions	797	1,020	307
Less material holdings	(242)	(132)	(85)
Total Tier 1 capital	41,563	40,852	41,020
Tier 2			
Reserves arising on revaluation of property and unrealised gains on AFS equities	74	184	154
Collective impairment provisions	672	796	666
Perpetual subordinated debt	4,925	7,170	12,085
Term subordinated debt	18,067	18,860	16,488
Non-controlling and other interests in Tier 2 capital	11	11	11
Less excess of expected loss over provisions	(2,795)	(3,580)	(1,079)
Less securitisation positions	(1,916)	(1,270)	(561)
Less material holdings	(242)	(132)	(85)
Less APS first loss	(4,225)	(4,654)	—
Total Tier 2 capital	14,571	17,385	27,679
Supervisory deductions			
Unconsolidated investments	(116)	(121)	(119)
Other deductions	(267)	(93)	(111)
Deductions from total capital	(383)	(214)	(230)
Total regulatory capital	55,751	58,023	68,469

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 RBS 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 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.

31 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		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Contingent liabilities						
Guarantees and assets pledged as collateral security	22,946	31,926	15,075	17,195	26,272	7,248
Other contingent liabilities	10,033	11,183	17,842	7,976	8,829	15,067
	32,979	43,109	32,917	25,171	35,101	22,315
Commitments						
Undrawn formal standby facilities, credit lines and other commitments to lend						
- less than one year	114,112	119,449	156,290	46,751	54,097	75,800
- one year and over	120,091	129,080	138,059	97,525	104,655	111,241
Other commitments	4,053	3,408	6,788	1,124	287	366
	238,256	251,937	301,137	145,400	159,039	187,407

Note:

- (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.

Notes on the accounts continued

31 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		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Operating leases						
Minimum rentals payable under non-cancellable leases (1)						
Within 1 year	409	399	407	171	165	159
After 1 year but within 5 years	1,327	1,301	1,354	595	612	586
After 5 years	2,651	2,729	3,010	1,621	1,674	1,808
	4,387	4,429	4,771	2,387	2,451	2,553
Property, plant and equipment						
Contracts to buy, enhance or maintain investment properties	—	—	7	—	—	—
Contracts to buy assets to be leased under operating leases (2)	2,590	2,724	6,063	—	—	—
Other capital expenditure	150	62	97	23	27	39
	2,740	2,786	6,167	23	27	39
Contracts to purchase goods or services (3)						
	385	611	1,157	318	402	419
	7,512	7,826	12,095	2,728	2,880	3,011
Included above are obligations to fellow subsidiaries						
Within 1 year	7	7	7	7	7	7
After 1 year but within 5 years	27	27	28	27	27	28
After 5 years	35	42	49	35	42	49
	69	76	84	69	76	84

Notes:

(1) Predominantly property leases.

(2) Of which due within 1 year: Group - £263 million (2009 - £370 million; 2008 - £3,769 million); Bank - nil (2009 and 2008 - nil).

(3) Of which due within 1 year: Group - £278 million (2009 - £441 million; 2008 - £872 million); Bank - £217 million (2009 - £239 million; 2008 - £235 million).

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 £407 million (2009 - £415 million; 2008 - £476 million) from these activities.

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.

The 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 31 March 2012. The annual limit on the FSCS interest and management expenses levy for the period September 2008 to March 2012 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. After the interest only period a schedule for repayment of any outstanding borrowings will be agreed between the FSCS and HM Treasury in the light of market conditions at that time and 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.

The Group has accrued £144 million for its share of FSCS management expenses levies for the 2010/11 and 2011/12 scheme years.

Bank levy

In his 22 June 2010 budget statement, the Chancellor announced that the UK Government will introduce an annual bank levy. The Finance Bill 2011 contains details of how the levy will be calculated and collected. The levy will be collected through the existing quarterly Corporation Tax collection mechanism starting with payment dates on or after the date the Finance Bill 2011 receives Royal Assent.

The levy will be based upon the total chargeable equity and liabilities as reported in the balance sheet at the end of a chargeable period. In determining the chargeable equity and liabilities the following amounts are excluded: Tier 1 capital; certain "protected deposits" (for example those protected under the Financial Services Compensation Scheme); liabilities that arise from certain insurance business within banking groups; liabilities in respect of currency notes in circulation; Financial Services Compensation Scheme liabilities; liabilities representing segregated client money; and deferred tax liabilities, current tax liabilities, liabilities in respect of the levy, revaluation of property liabilities, liabilities representing the revaluation of business premises and defined benefit retirement liabilities. It will also be permitted in specified circumstances to reduce certain liabilities by: netting them against certain assets; offsetting assets on the relevant balance sheets that would qualify as high quality liquid assets (in accordance with the FSA definition); and repo liabilities secured against sovereign and supranational debt.

Three different levy rates apply in 2011, these average to 0.075 per cent. From 2012 the levy rate increases to 0.078 per cent. Certain liabilities will be subject to only a half rate, namely any deposits not otherwise excluded, (except for those from financial institutions and financial traders) and liabilities with a maturity greater than one year at the balance sheet date. The levy will not be charged on the first £20 billion of chargeable liabilities.

Litigation

As a participant in the financial services industry, RBS 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, 'Litigation', so far as the Group is aware, neither the Bank nor any of its subsidiaries 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 the US, Citizens Financial Group, in common with other US banks, has been named as a defendant in a class action asserting that Citizens charges excessive overdraft fees. The plaintiffs claim that overdraft fees resulting from point of sale and automated teller machine (ATM) transactions violate the duty of good faith implied in Citizens' customer account agreement and constitute an unfair trade practice. RBS Group considers that it has substantial and credible legal and factual defences to these claims and will defend them vigorously. 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.

Shareholder litigation

RBS Group 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 US Securities Act of 1933, Sections 10 and 20 of the US Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder.

The putative class is composed of (1) all persons who purchased or otherwise acquired RBSG ordinary securities and US American depositary receipts (ADRs) between 1 March 2007 and 19 January 2009; and/or (2) all persons who purchased or otherwise acquired RBSG Series Q, R, S, T and/or U non-cumulative dollar preference shares issued pursuant or traceable to the 8 April 2005 US Securities and Exchange Commission (SEC) registration statement and were damaged thereby. Plaintiffs seek unquantified damages on behalf of the putative class.

On 11 January 2011, the District Court dismissed all claims except those based on the purchase of RBSG Series Q, R, S, T, and/or U non-cumulative dollar preference shares. The Court has not yet considered potential grounds for dismissal of the remaining claims, and RBS Group's motion to dismiss those remaining claims is to be submitted on a date which is still to be determined. In January and February 2011, two new complaints were filed asserting claims under Sections 10 and 20 of the Exchange Act on behalf of a putative class of purchasers of ADRs. A motion to consolidate those claims with the preference share claims is currently pending.

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 the remaining and prospective claims and will defend them vigorously. RBS Group is unable to reliably 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.

31 Memorandum items *continued*

Other securitisation and securities related litigation in the United States

RBS Group companies have been named as defendants in a number of purported class actions 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. RBS Group cannot at this stage reliably estimate the liability, if any, that may arise as a result of or in connection with 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 any of these other claims and proceedings will have a significant effect on the Group’s financial position or profitability in any particular period.

Investigations

The 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. 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 regarding operational, systems and control evaluations and issues including those related to compliance with applicable anti-bribery, anti-money laundering and applicable sanctions regimes. It is possible that any matters discussed or identified may result in investigatory or other action being taken by the regulators, increased costs being incurred by the Group, remediation of systems and controls, public or private censure, restriction of the Group’s business activities or fines. Any of these events or circumstances could have a significant effect on the Group, its business, authorisations and licences, reputation, results of operations or the price of securities issued by it.

Political and regulatory scrutiny of the operation of retail banking and consumer credit industries in the United Kingdom and elsewhere continues. The nature and impact of future changes in policies and regulatory action are not predictable and are beyond RBS Group’s control but could have a significant effect 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 (EC) announced that barriers to competition in certain areas of retail banking, payment cards and payment systems in the European Union had been identified. The EC 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. In addition in late 2010, the EC launched an initiative pressing for increased transparency of bank fees.

Multilateral interchange fees

In 2007, the EC 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 MIF (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 RBS Group has intervened in the appeal proceedings. In addition, in summer 2008, MasterCard announced various changes to its scheme arrangements. The EC 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 EC pending the outcome of the appeal process and, as a result, the EC 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 EC for a period of five years up to 31 December 2007 subject to certain conditions. On 26 March 2008, the EC 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 EC 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. However on 26 April 2010 Visa announced it had reached an agreement with the EC as regards immediate cross border debit card MIF rates only and in December 2010 the commitments were finalised for a four year period commencing December 2010 under Article 9 of Regulation 1/2003. The EC is continuing its investigations into Visa’s cross border MIF arrangements for deferral debit and credit transactions.

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 General 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 a significant effect on the consumer credit industry in general and, therefore, on the 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 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. On 14 May 2010, the CC published its Provisional Decision following its review of remedies in the PPI market indicating that the CC still intends to impose a prohibition on selling PPI at point of sale of the credit product. On 14 October, 2010 the CC published its final decision on remedies following the remittal which confirmed the point of sale prohibition. The CC made the final order in March 2011, with the key measures coming into force in October 2011 and April 2012.

The Financial Services Authority (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 Financial Ombudsman Service (FOS) and many of these are being upheld by the FOS against the banks.

Following unsuccessful negotiations with the industry, the FSA issued consultation papers on PPI complaint handling and redress in September 2009 and again in March 2010. The FSA published its final policy statement on 10 August 2010 and instructed firms to implement the measures contained in it by 1 December 2010. The new rules impose significant changes with respect to the handling of mis-selling PPI complaints. On 8 October 2010, the British Bankers Association filed an application for judicial review of the FSA's policy statement and of related guidance issued by the FOS. The court hearing took place from 25 to 28 January 2011 and judgment is awaited. RBS Group is unable to reliably estimate the liability, if any, that might arise from this litigation or its effect on the Group's consolidated net assets, operating results or cash flows in any particular period. Separately, discussions continue between the FSA and 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 (PCA) in the United Kingdom. The OFT found evidence of competition and several positive features in the personal current account market but believed that the market as a whole was not working well for consumers and that the ability of the market to function well had 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. On 16 March 2010 the OFT announced that it had secured agreement from the banks on four industry-wide initiatives, namely minimum standards on the operation of opt-outs from unarranged overdrafts, new working groups on information sharing with customers, best practice for PCA customers in financial difficulties and incurring charges, and PCA providers to publish their policies on dealing with PCA customers in financial difficulties. The OFT also announced its plan to conduct six-monthly ongoing reviews, to fully review the market again in 2012 and to undertake a brief analysis on barriers to entry. The first six-monthly ongoing review was completed in September 2010. The OFT noted progress in the areas of switching, transparency and unarranged overdrafts for the period March to September 2010, as well as highlighting further changes the OFT expects to see in the market. The next progress report is expected to be published by the OFT in March 2011.

On 26 May 2010, the OFT announced its review of barriers to entry. The review concerns retail banking for individuals and small and medium size enterprises (up to £25 million turnover) and will look at products which require a banking licence to sell mortgages, loan products and, where appropriate, other products such as insurance or credit cards where cross-selling may facilitate entry or expansion. The OFT published its report in November 2010. It advised that it expected its review to be relevant to the Independent Commission on Banking, the FSA, HM Treasury and the Department for Business, Innovation and Skills and to the devolved governments in the United Kingdom. The OFT has not indicated whether it will undertake any further work. The report maintained that barriers to entry remain, in particular regarding switching, branch networks and brands. At this stage, it is not possible to estimate the effect of the OFT's report and recommendations regarding barriers to entry upon RBS Group.

31 Memorandum items continued

Equity underwriting

On 10 June 2010, the OFT announced its intention to conduct a market study into equity underwriting and related services and sought views on scope by 9 July 2010. The OFT study was formally launched on 6 August 2010. The OFT undertook to examine the underwriting services for the different types of share issue used by FTSE 350 firms to raise capital in the UK, including rights issues, placings and follow-on offers but excluding initial public offerings. The OFT has been looking at the way that the market works and the following three key issues: (i) how underwriting services are purchased; (ii) how underwriting services are provided; and (iii) how the regulatory environment affects the provision of underwriting services. The OFT published its report on 27 January 2011 identifying certain concerns around the level of equity underwriting fees. The OFT has identified a number of options which would enable companies and institutional shareholders to address these concerns and allow them to drive greater competition in the market. It is currently consulting on its provisional decision not to refer the market to the CC. RBS Group is engaged in the OFT market study and it is not possible to estimate with any certainty what effect this study and any related developments may have on the Group, its business or results of operations.

Independent Commission on Banking

On 16 June 2010, HM Treasury published the terms of reference for the Government's Independent Commission on Banking (ICB). The ICB is considering the structure of the United Kingdom banking sector and is looking at structural and non-structural measures to reform the banking system and to promote competition. It is mandated to formulate policy recommendations with a view to: (i) reducing systemic risk in the banking sector, exploring the risk posed by banks of different size, scale and function; (ii) mitigating moral hazard in the banking system; (iii) reducing the likelihood and impact of a bank's failure; and (iv) promoting competition in retail and investment banking with a view to ensuring that the needs of banks' customers are served efficiently and considering the extent to which large banks can gain competitive advantage from being perceived as "too big to fail".

The ICB reports to the Cabinet Committee on Banking Reform and is required to produce a final report by the end of September 2011. RBS Group has responded to the call for evidence by the ICB. In addition it has attended a private hearing, as well as public hearings in Edinburgh and Cardiff in December 2010. An Issues Paper by the ICB is expected in Spring 2011. At this stage it is not possible to estimate the effect of the ICB's report and recommendations upon the RBS Group, if any.

Securitisation and collateralised debt obligation business

In September and October 2010, the SEC requested voluntary production of information concerning residential mortgage backed securities underwritten by subsidiaries of RBS Group during the period from September 2006 to July 2007 inclusive. In November 2010, the SEC commenced formal proceedings and requested testimony from RBS employees. The investigation is in its preliminary stages and it is difficult to predict any potential exposure that may result.

In June 2009, in connection with an investigation into the role of investment banks in the origination and securitisation of sub prime loans in Massachusetts, the Massachusetts Attorney General issued subpoenas to various banks, including an RBS Group subsidiary, seeking information related to residential mortgage lending practices and sales and securitisation of residential mortgage loans. This investigation is ongoing and RBS Group is co-operating.

Previously, in 2008, the New York State Attorney General 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 Group completed its production of documents requested by the New York State Attorney General in 2009, principally producing documents related to loans that were pooled into one securitisation transaction. More recently, in September 2010, RBS Group subsidiaries received a request from the Nevada State Attorney General requesting information related to securitisations of mortgages issued by three specific originators. The investigation by the Nevada Attorney General is in the early stages and therefore it is difficult to predict the potential exposure from any such investigation. RBS Group and its subsidiaries are co-operating with these various investigations and requests.

US mortgages

RBS's Global Banking & Markets N.A. (GBM N.A.), has been a purchaser of non-agency US residential mortgages in the secondary market, and an issuer and underwriter of non-agency residential mortgage backed securities (RMBS). GBM N.A. did not originate or service any US residential mortgages and it was not a significant seller of mortgage loans to government sponsored enterprises (GSEs) (e.g. the Federal National Mortgage Association and the Federal Home Loan Mortgage Association).

In issuing RMBS, GBM N.A. generally assigned certain representations and warranties regarding the characteristics of the underlying loans made by the originator of the residential mortgages; however, in some circumstances, GBM N.A. made such representations and warranties itself. Where GBM N.A. has given those or other representations and warranties (whether relating to underlying loans or otherwise), GBM N.A. may be contractually required to repurchase such loans or indemnify certain parties against losses for certain breaches of such representations and warranties. In certain instances where it is required to repurchase loans or related securities, GBM N.A. may be able to assert claims against third parties who provided representations or warranties to GBM N.A. when selling loans to it; although the ability to make recoveries against such parties and outcome of such claims would be uncertain. During the two-year period ended 31 December 2010, GBM N.A. has received approximately US\$38 million in repurchase demands in respect of loans made and related securities sold where obligations in respect of contractual representations or warranties were undertaken by GBM N.A. However, repurchase demands presented to GBM N.A. are subject to challenge and, to date, GBM N.A. has rebutted a significant percentage of these claims.

GBM N.A. has been named as a defendant in a number of suits relating to its role as issuer and underwriter of RMBS (see section above 'other securitisation and securities related litigation in the United States'). Those lawsuits are in their early stages and we are not able to predict the outcome of such proceedings or their effect on the Group.

Citizens Financial Group (CFG) has not been an issuer or underwriter of non-agency RMBS. However, CFG is an originator and servicer of residential mortgages, and it routinely sells such mortgage loans in the secondary market and to GSEs. In the context of such sales, CFG makes certain representations and warranties regarding the characteristics of the underlying loans and, as a result, may be contractually required to repurchase such loans or indemnify certain parties against losses for certain breaches of the representations and warranties concerning the underlying loans. During the two-year period ended 31 December 2010, CFG has received approximately US\$26 million in repurchase demands in respect of loans originated. However, repurchase demands presented to CFG are subject to challenge and, to date, CFG has rebutted a significant percentage of these claims.

Although there has been disruption in the ability of certain financial institutions operating in the United States to complete foreclosure proceedings in respect of US mortgage loans in a timely manner (or at all) over the last year (including as a result of interventions by certain states and local governments), to date, CFG has not been materially impacted by such disruptions and the Group has not ceased making foreclosures.

The RBS Group cannot estimate what the future level of repurchase demands or ultimate exposure of GBM N.A. or CFG may be, and cannot give any assurance that the historical experience will continue in the future. Furthermore, the RBS Group is unable to estimate the extent to which the matters described above will impact it and future developments may have an adverse impact on the Group's business, financial condition, results of operations, cash flow and the value of its securities.

Other investigations

In April 2009, the FSA notified 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. RBS Group and its subsidiaries cooperated fully with this review and investigation. On 2 December 2010, the FSA confirmed that it had completed its investigation and had concluded that no enforcement action, either against RBS Group or against individuals, was warranted. RBS Group is engaging constructively with the FSA with regard to the publication of a report by the FSA relating to the supervisory review, subject to any necessary commercial constraints.

In July 2010, the FSA notified RBS Group that it was commencing an investigation into the sale by Coutts & Co of ALICO (American Life Insurance Company) Premier Access Bond Enhanced Variable Rate Fund to customers between 2001 and 2008 as well as its subsequent review of those sales. On 11 January 2011, the FSA amended the date range on which its investigation is focussed and the investigation start date is now December 2003. RBS Group and its subsidiaries are cooperating fully with this investigation.

In the United States, 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, RBS Group was advised by the SEC that it had commenced a non-public, formal investigation relating to RBS Group's United States sub-prime securities exposures and United States residential mortgage exposures. RBS Group and its subsidiaries are cooperating with these various requests for information and investigations.

The Federal Reserve and state banking supervisors have been reviewing RBS Group's US operations and RBS Group and its subsidiaries have been required to make improvements with respect to various matters, including enterprise-wide governance, Bank Secrecy Act and anti-money laundering compliance, risk management and asset quality. RBS Group is in the process of implementing measures for matters identified to date. RBS Group may become subject to formal and informal supervisory actions and may be required by its US banking supervisors to take further actions and implement additional remedial measures with respect to these and additional matters. Any limitations or conditions placed on RBS Group's activities in the United States, as well as the terms of any supervisory action applicable to RBS Group and its subsidiaries, could have a material adverse effect on the Group's business, results of operations and financial condition.

32 Net cash inflow/(outflow) from operating activities

	Group			Bank		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Operating (loss)/profit before tax	(171)	(3)	(9,216)	384	(1,142)	(2,373)
(Increase)/decrease in prepayments and accrued income	(247)	28	(513)	(261)	295	(426)
Interest on subordinated liabilities	816	959	1,694	647	672	1,487
(Decrease)/increase in accruals and deferred income	(471)	(36)	2,497	(922)	(395)	2,089
Provisions for impairment losses	9,400	12,174	4,706	3,571	5,924	2,007
Loans and advances written-off net of recoveries	(4,015)	(5,409)	(2,236)	(2,392)	(2,635)	(737)
Unwind of discount on impairment losses	(444)	(356)	(174)	(113)	(96)	(61)
(Profit)/loss on sale of property, plant and equipment	(50)	(40)	(177)	1	(2)	(4)
(Profit)/loss on sale of subsidiaries and associates	(675)	16	(417)	305	69	(617)
(Profit)/loss on sale of securities	(253)	(312)	(174)	11	(228)	(94)
Charge for defined benefit pension schemes	489	389	351	8	(4)	8
Pension scheme curtailment gains	(78)	(2,148)	—	—	(1,603)	—
Cash contribution to defined benefit pension schemes	(641)	(744)	(491)	(3)	(1)	(8)
Other provisions utilised	(207)	(148)	(24)	(156)	(119)	(14)
Depreciation and amortisation	1,689	1,587	1,562	561	495	483
Gain on redemption of own debt	(502)	(2,694)	—	(345)	(2,255)	—
Write-down of goodwill and other intangible assets	1	118	8,144	—	—	215
Elimination of foreign exchange differences	(3,107)	5,715	(20,997)	(1,745)	3,623	(16,892)
Other non-cash items	768	1,335	1,586	116	(113)	2,861
Net cash inflow/(outflow) from trading activities	2,302	10,431	(13,879)	(333)	2,485	(12,076)
Decrease/(increase) in loans and advances to banks and customers	13,305	81,038	(69,339)	(16,018)	(11,118)	(10,544)
Decrease/(increase) in securities	13,077	(3,742)	19,719	14,914	(5,430)	14,127
Decrease/(increase) in other assets	1,830	(6,029)	(4,494)	10,248	(6,291)	(3,920)
Decrease/(increase) in derivative assets	16,967	484,743	(724,306)	17,721	484,768	(730,592)
Changes in operating assets	45,179	556,010	(778,420)	26,865	461,929	(730,929)
(Decrease)/increase in deposits by banks and customers	(11,297)	(63,163)	42,367	15,042	50,027	35,638
(Decrease)/increase in debt securities in issue	(9,609)	(9,213)	49,810	(3,148)	13,201	35,272
Increase/(decrease) in other liabilities	3,560	637	(3,650)	(5,316)	738	2,102
(Decrease)/increase in derivative liabilities	(3,554)	(478,299)	706,052	(5,481)	(478,203)	706,940
Increase/(decrease) in settlement balances and short positions	5,640	(474)	(13,314)	1,308	(335)	(7,605)
Changes in operating liabilities	(15,260)	(550,512)	781,265	2,405	(414,572)	772,347
Total income taxes received/(paid)	771	(785)	(886)	507	2	83
Net cash inflow/(outflow) from operating activities	32,992	15,144	(11,920)	29,444	49,844	29,425

33 Analysis of the net investment in business interests and intangible assets

	Group			Bank		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Acquisitions and disposals						
Fair value given for businesses acquired	(195)	(73)	(1,491)	(169)	(31)	(47)
Additional investments in Group undertakings	—	—	—	(3,015)	(3,766)	(4,155)
Net outflow of cash in respect of purchases	(195)	(73)	(1,491)	(3,184)	(3,797)	(4,202)
Other assets sold	2,790	78	552	(3)	1	146
Repayment of investments	—	—	—	5,072	914	349
Non-cash consideration	—	—	(35)	899	—	—
Profit/(loss) on disposal	675	(16)	417	(305)	(69)	617
Net inflow of cash in respect of disposals	3,465	62	934	5,663	846	1,112
Dividends received from joint ventures	5	—	9	2	—	3
Cash expenditure on intangible assets	(668)	(386)	(360)	(441)	(174)	(177)
Net inflow/(outflow)	2,607	(397)	(908)	2,040	(3,125)	(3,264)

34 Interest received and paid

	Group			Bank		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
Interest received	19,531	23,120	30,876	14,029	12,375	16,169
Interest paid	(6,985)	(12,508)	(17,581)	(9,707)	(8,242)	(11,576)
	12,546	10,612	13,295	4,322	4,133	4,593

35 Analysis of changes in financing during the year

	Group					
	Share capital, share premium and merger reserve			Subordinated liabilities		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
At 1 January	42,865	42,539	32,539	34,717	39,951	27,796
Issue of ordinary shares	—	8,151	10,000			
Redemption of preference shares	—	(7,825)	—			
Issue of subordinated liabilities				—	5,000	5,055
Repayment of subordinated liabilities				(880)	(3,200)	(1,035)
Net cash inflow/(outflow) from financing	—	326	10,000	(880)	1,800	4,020
Currency translation and other adjustments	—	—	—	(1,814)	(7,034)	8,135
At 31 December	42,865	42,865	42,539	32,023	34,717	39,951

	Bank					
	Share capital and share premium			Subordinated liabilities		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
At 1 January	31,984	31,658	21,658	30,513	33,698	22,745
Issue of ordinary shares	—	8,151	10,000			
Redemption of preference shares	—	(7,825)	—			
Issue of subordinated liabilities				—	5,000	5,055
Repayment of subordinated liabilities				(8)	(2,235)	(1,035)
Net cash inflow/(outflow) from financing	—	326	10,000	(8)	2,765	4,020
Currency translation and other adjustments	—	—	—	(1,206)	(5,950)	6,933
At 31 December	31,984	31,984	31,658	29,299	30,513	33,698

36 Analysis of cash and cash equivalents

	Group			Bank		
	2010 £m	2009 £m	2008 £m	2010 £m	2009 £m	2008 £m
At 1 January						
- cash	57,954	47,223	27,289	47,039	39,093	16,591
- cash equivalents	34,984	33,191	57,472	31,677	34,356	60,658
	92,938	80,414	84,761	78,716	73,449	77,249
Net cash inflow/(outflow)	36,239	12,524	(4,347)	35,663	5,267	(3,800)
At 31 December	129,177	92,938	80,414	114,379	78,716	73,449
Comprising:						
Cash and balances at central banks	49,423	26,627	6,442	44,584	20,744	3,432
Treasury bills and debt securities	3,937	13,626	14,006	3,439	13,626	14,006
Loans and advances to banks	75,817	52,685	59,966	66,356	44,346	56,011
Cash and cash equivalents	129,177	92,938	80,414	114,379	78,716	73,449

The Bank and certain subsidiary undertakings are required to maintain balances with the Bank of England which, at 31 December 2010, amounted to £337 million (2009 - £354 million; 2008 - £282 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 2010 (2009 and 2008 - nil).

37 Segmental analysis

(a) Divisions

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 reportable segments are on a divisional basis as follows:

UK Retail offers a comprehensive range of banking products and related financial services to the personal market. It serves customers through the RBS and NatWest network 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.

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 Transaction Services (GTS) 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.

Ulster Bank is the leading retail and business bank in Northern Ireland and the third largest banking group on the island of Ireland. It provides a comprehensive range of financial services. The Retail Markets division, which has a network of 236 branches, operates in the personal and financial planning sectors. The Corporate Markets division 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.

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 and mortgage markets and portfolio management and origination.

Central items 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, 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.

	Net interest income £m	Non-interest income £m	Total income £m	Operating expenses £m	Depreciation and amortisation £m	Impairment losses £m	Operating profit/(loss) £m
2010							
UK Retail	4,082	1,119	5,201	(2,564)	(1)	(1,160)	1,476
UK Corporate	2,584	1,323	3,907	(1,392)	(173)	(761)	1,581
Wealth	554	445	999	(683)	(11)	(18)	287
Global Transaction Services	421	1,325	1,746	(863)	(5)	(14)	864
Ulster Bank	860	214	1,074	(535)	(2)	(1,161)	(624)
US Retail & Commercial	1,948	1,029	2,977	(1,934)	(99)	(517)	427
Global Banking & Markets	901	5,519	6,420	(2,792)	(104)	(289)	3,235
Central items	(850)	392	(458)	(112)	(735)	(4)	(1,309)
Core	10,500	11,366	21,866	(10,875)	(1,130)	(3,924)	5,937
Non-Core	1,611	661	2,272	(1,051)	(480)	(5,476)	(4,735)
	12,111	12,027	24,138	(11,926)	(1,610)	(9,400)	1,202
Reconciling items							
Fair value of own debt	—	(31)	(31)	—	—	—	(31)
Amortisation of purchased intangible assets	—	—	—	—	(63)	—	(63)
Integration and restructuring costs	—	—	—	(809)	(16)	—	(825)
Gain on redemption of own debt	—	502	502	—	—	—	502
Strategic disposals	—	645	645	—	—	—	645
Bonus tax	—	—	—	(50)	—	—	(50)
Asset Protection Scheme credit default swap - fair value changes	—	(1,550)	(1,550)	—	—	—	(1,550)
Write-down of goodwill and other intangible assets	—	—	—	(1)	—	—	(1)
	12,111	11,593	23,704	(12,786)	(1,689)	(9,400)	(171)
2009							
UK Retail	3,535	1,289	4,824	(2,723)	(2)	(1,679)	420
UK Corporate	2,249	1,290	3,539	(1,294)	(154)	(927)	1,164
Wealth	564	445	1,009	(607)	(11)	(33)	358
Global Transaction Services	447	1,292	1,739	(880)	(12)	(16)	831
Ulster Bank	829	254	1,083	(710)	(5)	(649)	(281)
US Retail & Commercial	1,907	949	2,856	(1,988)	(72)	(702)	94
Global Banking & Markets	1,088	7,276	8,364	(2,429)	(59)	(317)	5,559
Central items	(941)	91	(850)	(245)	(734)	—	(1,829)
Core	9,678	12,886	22,564	(10,876)	(1,049)	(4,323)	6,316
Non-Core	1,865	(2,282)	(417)	(947)	(439)	(7,851)	(9,654)
	11,543	10,604	22,147	(11,823)	(1,488)	(12,174)	(3,338)
Reconciling items							
Fair value of own debt	—	(298)	(298)	—	—	—	(298)
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
Gains on pensions curtailment	—	—	—	2,148	—	—	2,148
Bonus tax	—	—	—	(151)	—	—	(151)
Write-down of goodwill and other intangible assets	—	—	—	(118)	—	—	(118)
	11,543	13,000	24,543	(10,785)	(1,587)	(12,174)	(3)

Notes on the accounts continued

37 Segmental analysis continued

2008	Net interest income £m	Non-interest income £m	Total income £m	Operating expenses £m	Depreciation and amortisation £m	Impairment losses £m	Operating profit/(loss) £m
UK Retail	3,254	1,546	4,800	(2,901)	(2)	(1,019)	878
UK Corporate	2,382	1,288	3,670	(1,418)	(150)	(319)	1,783
Wealth	661	479	1,140	(665)	(9)	(16)	450
Global Transaction Services	492	1,193	1,685	(791)	(1)	(30)	863
Ulster Bank	849	266	1,115	(687)	1	(106)	323
US Retail & Commercial	1,817	861	2,678	(1,408)	(151)	(437)	682
Global Banking & Markets	1,346	10	1,356	(1,423)	(97)	(237)	(401)
Central items	1,226	(1,486)	(260)	253	(579)	(2)	(588)
Core	12,027	4,157	16,184	(9,040)	(988)	(2,166)	3,990
Non-Core	1,482	(3,171)	(1,689)	(996)	(452)	(2,540)	(5,677)
	13,509	986	14,495	(10,036)	(1,440)	(4,706)	(1,687)
Reconciling items							
Fair value of own debt	—	920	920	—	—	—	920
Amortisation of purchased intangible assets	—	—	—	—	(100)	—	(100)
Integration and restructuring costs	—	—	—	(625)	(22)	—	(647)
Strategic disposals	—	442	442	—	—	—	442
Write-down of goodwill and other intangible assets	—	—	—	(8,144)	—	—	(8,144)
	13,509	2,348	15,857	(18,805)	(1,562)	(4,706)	(9,216)

	2010			2009			2008		
	External £m	Inter segment £m	Total £m	External £m	Inter segment £m	Total £m	External £m	Inter segment £m	Total £m
Total revenue									
UK Retail	6,656	358	7,014	6,760	550	7,310	7,865	1,642	9,507
UK Corporate	4,348	126	4,474	4,557	116	4,673	8,292	225	8,517
Wealth	956	616	1,572	812	818	1,630	1,123	2,119	3,242
Global Transaction Services	2,330	6	2,336	2,282	60	2,342	2,223	81	2,304
Ulster Bank	1,386	133	1,519	1,605	103	1,708	2,925	585	3,510
US Retail & Commercial	3,660	286	3,946	4,080	378	4,458	4,200	475	4,675
Global Banking & Markets	7,824	4,331	12,155	10,630	7,971	18,601	3,892	10,271	14,163
Central items	2,237	12,251	14,488	35	9,289	9,324	(329)	11,310	10,981
Core	29,397	18,107	47,504	30,761	19,285	50,046	30,191	26,708	56,899
Non-Core	4,107	194	4,301	2,975	1,254	4,229	3,941	1,561	5,502
	33,504	18,301	51,805	33,736	20,539	54,275	34,132	28,269	62,401
Eliminations	—	(18,301)	(18,301)	—	(20,539)	(20,539)	—	(28,269)	(28,269)
	33,504	—	33,504	33,736	—	33,736	34,132	—	34,132
Reconciling items									
Fair value of own debt	(31)	—	(31)	(298)	—	(298)	920	—	920
Gain on redemption of own debt	502	—	502	2,694	—	2,694	—	—	—
Strategic disposals	645	—	645	—	—	—	442	—	442
Asset Protection Scheme credit default swap - fair value changes	(1,550)	—	(1,550)	—	—	—	—	—	—
	33,070	—	33,070	36,132	—	36,132	35,494	—	35,494

	2010			2009			2008		
	External £m	Inter segment £m	Total £m	External £m	Inter segment £m	Total £m	External £m	Inter segment £m	Total £m
Total income									
UK Retail	5,245	(44)	5,201	4,916	(92)	4,824	5,088	(288)	4,800
UK Corporate	4,361	(454)	3,907	4,379	(840)	3,539	6,305	(2,635)	3,670
Wealth	507	492	999	310	699	1,009	(683)	1,823	1,140
Global Transaction Services	1,749	(3)	1,746	1,748	(9)	1,739	1,712	(27)	1,685
Ulster Bank	962	112	1,074	1,049	34	1,083	1,535	(420)	1,115
US Retail & Commercial	2,703	274	2,977	2,513	343	2,856	2,231	447	2,678
Global Banking & Markets	6,132	288	6,420	7,819	545	8,364	(137)	1,493	1,356
Central items	(1,054)	596	(458)	(2,725)	1,875	(850)	(4,133)	3,873	(260)
Core	20,605	1,261	21,866	20,009	2,555	22,564	11,918	4,266	16,184
Non-Core	3,533	(1,261)	2,272	2,138	(2,555)	(417)	2,577	(4,266)	(1,689)
	24,138	—	24,138	22,147	—	22,147	14,495	—	14,495
Reconciling items									
Fair value of own debt	(31)	—	(31)	(298)	—	(298)	920	—	920
Gain on redemption of own debt	502	—	502	2,694	—	2,694	—	—	—
Strategic disposals	645	—	645	—	—	—	442	—	442
Asset Protection Scheme credit default swap - fair value changes	(1,550)	—	(1,550)	—	—	—	—	—	—
	23,704	—	23,704	24,543	—	24,543	15,857	—	15,857

	2010			2009			2008		
	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	112,070	100,324	—	107,136	88,006	—	98,636	78,999	6
UK Corporate	114,008	101,740	381	114,205	89,306	598	120,152	83,907	1,418
Wealth	21,178	37,071	63	18,104	36,278	11	16,320	35,081	41
Global Transaction Services	14,652	45,032	22	10,286	41,192	17	11,870	39,373	5
Ulster Bank	40,090	34,512	101	44,031	40,621	—	49,114	47,972	1
US Retail & Commercial	71,200	66,089	197	75,384	72,408	179	88,673	89,255	204
Global Banking & Markets	719,330	704,656	508	731,379	749,190	540	1,186,045	1,264,750	791
Central items	68,970	126,768	897	40,795	116,792	603	29,938	97,605	975
Core	1,161,498	1,216,192	2,169	1,141,320	1,233,793	1,948	1,600,748	1,736,942	3,441
Non-Core	145,832	33,531	761	191,661	42,991	2,910	277,182	93,738	1,964
Group	1,307,330	1,249,723	2,930	1,332,981	1,276,784	4,858	1,877,930	1,830,680	5,405

Notes on the accounts continued

37 Segmental analysis continued

Segmental analysis of goodwill is as follows:

	UK Retail £m	UK Corporate £m	Wealth £m	Global Transaction Services £m	Ulster Bank £m	US Retail & Commercial £m	Global Banking & Markets £m	Central items £m	Non-Core £m	Total £m
At 1 January 2008	2,790	2,741	753	1,641	858	5,392	1,059	24	1,525	16,783
Currency translation and other adjustments	—	—	56	424	133	2,013	2	—	61	2,689
Acquisitions	—	—	—	—	—	—	—	—	211	211
Disposals	—	—	—	—	—	—	—	—	(47)	(47)
Write-down of goodwill	—	(46)	(9)	—	(991)	(4,382)	(1,023)	—	(1,353)	(7,804)
At 1 January 2009	2,790	2,695	800	2,065	—	3,023	38	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 1 January 2010	2,790	2,695	788	1,897	—	2,721	64	24	28	11,007
Currency translation and other adjustments	—	—	25	62	—	122	4	—	1	214
Disposals	—	—	—	(481)	—	—	—	—	(14)	(495)
Write-down of goodwill	—	—	(1)	—	—	—	—	—	—	(1)
At 31 December 2010	2,790	2,695	812	1,478	—	2,843	68	24	15	10,725

(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				Total £m
	UK £m	USA £m	Europe £m	Rest of the World £m	
2010					
Total revenue	19,692	8,096	3,474	1,808	33,070
Net interest income	8,205	2,508	1,147	251	12,111
Net fees and commissions	3,524	1,510	366	131	5,531
Income from trading activities	1,298	1,928	23	112	3,361
Other operating income/(loss)	1,761	222	786	(68)	2,701
Total income	14,788	6,168	2,322	426	23,704
Operating profit/(loss) before tax	583	1,596	(2,237)	(113)	(171)
Total assets	869,662	333,946	43,499	60,223	1,307,330
Total liabilities	839,747	316,515	33,906	59,555	1,249,723
Net assets attributable to equity shareholders and non-controlling interests	29,915	17,431	9,593	668	57,607
Contingent liabilities and commitments	142,909	86,482	33,872	7,972	271,235
Cost to acquire property, plant and equipment and intangible assets	1,219	336	1,320	55	2,930
2009					
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 non-controlling 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	Group				Total £m
	UK £m	USA £m	Europe £m	Rest of the World £m	
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 non-controlling 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

38 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:

	2010 £000	2009 £000
Short-term benefits	35,654	29,292
Post-employment benefits	(503)	9,781
Share-based payments	21,551	8,953
	<u>56,702</u>	<u>48,026</u>

39 Transactions with directors and key management

(a) At 31 December 2010, the amounts outstanding in relation to transactions, arrangements and agreements entered into by authorised institutions in the Group, as defined in UK legislation, were £3,603,075 in respect of loans to seven 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:

	2010 £000	2009 £000
Loans and advances to customers	10,970	11,196
Customer accounts	10,641	11,713

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.

Notes on the accounts continued

40 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 2010 and 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 balances with the UK Government and UK Government controlled bodies were:

	Group				Bank			
	Central government (including the Bank of England) £m	Local government £m	Banks, financial corporations and public corporations £m	Total £m	Central government (including the Bank of England) £m	Local government £m	Banks, financial corporations and public corporations £m	Total £m
2010								
Assets								
Balances at central banks	18,853	—	—	18,853	18,481	—	—	18,481
Loans and advances to banks	—	—	674	674	—	—	674	674
Loans and advances to customers	46	1,427	1,170	2,643	—	1,112	833	1,945
Debt securities	10,619	—	136	10,755	10,618	—	136	10,754
Derivatives	73	4	96	173	73	4	96	173
Other	494	—	—	494	494	—	—	494
Liabilities								
Deposits by banks	147	—	419	566	147	—	418	565
Customer accounts	935	5,002	640	6,577	253	2,600	280	3,133
Derivatives	207	23	920	1,150	207	21	920	1,148
Other	186	—	—	186	186	—	—	186
2009								
Assets								
Balances at central banks	16,521	—	—	16,521	16,521	—	—	16,521
Loans and advances to banks	—	—	664	664	—	—	664	664
Loans and advances to customers	47	985	308	1,340	1	654	18	673
Debt securities	18,338	—	—	18,338	18,338	—	—	18,338
Derivatives	204	59	6	269	204	59	6	269
Other	4,514	—	—	4,514	4,514	—	—	4,514
Liabilities								
Deposits by banks	—	—	436	436	—	—	436	436
Customer accounts	218	1,814	310	2,342	218	1,814	310	2,342
Derivatives	155	33	7	195	155	33	7	195
Other	118	—	—	118	118	—	—	118

2008	Group				Bank			
	Central government (including the Bank of England) £m	Local government £m	Banks, financial corporations and public corporations £m	Total £m	Central government (including the Bank of England) £m	Local government £m	Banks, financial corporations and public corporations £m	Total £m
Assets								
Balances at central banks	282	—	—	282	282	—	—	282
Loans and advances to banks	—	—	1,053	1,053	—	—	1,053	1,053
Loans and advances to customers	1	575	431	1,007	—	399	14	413
Debt securities	19,732	—	—	19,732	19,111	—	—	19,111
Derivatives	1,286	60	10	1,356	1,286	60	10	1,356
Other	249	—	—	249	249	—	—	249
Liabilities								
Deposits by banks	26,541	—	605	27,146	26,541	—	605	27,146
Customer accounts	222	1,436	149	1,807	222	1,436	149	1,807
Derivatives	276	69	18	363	276	69	18	363
Other	176	—	—	176	176	—	—	176

No impairment losses were recognised by the Group or the Bank in 2010, 2009 or 2008 in respect of balances with the 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.

HMT has the right to appoint step-in managers to carry out any oversight, management or additional functions on behalf of HMT to ensure that the covered assets are managed and administered in compliance with the agreed terms and conditions. This right is exercisable if certain step-in triggers occur. These include:

- losses on covered assets in total exceed 125% of the first loss amount or losses on an individual covered asset class exceed specified thresholds;

- a breach of specified obligations in the APS rules or the accession agreement;
- the Group has failed or is failing to comply with any of the conditions in the APS rules in relation to asset management, monitoring and reporting, and governance and oversight and such failure is persistent and material or it is evidence of a systematic problem; and
- material or systematic data deficiencies in the information provided to HMT in accordance with the terms of APS.

HMT may at any time elect to cease to exercise its step-in rights in whole or part when it is satisfied that the step-in triggers have been remedied.

In consideration for the protection provided by the APS, the Group paid a premium of £700 million during 2010 (2009 - £1,400 million). Quarterly premiums of £125 million are payable from 31 December 2011 and subsequently 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 is recognised at fair value £550 million (2009 - £1,400 million) and included within the Derivative asset balance sheet caption.

Notes on the accounts *continued*

40 Related parties *continued*

Changes in fair value of £1,550 million (2009 - nil) were recognised in profit or loss within Income from trading activities. Details of the valuation methodology for the APS are set out in note 11 Financial Instruments - valuation on pages 176 and 177.

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. 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 RBS Holdings N.V., a fellow subsidiary, under which it has sold credit protection over the exposures held by RBS Holdings N.V. 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.
- 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 2010, the Group's utilisation of these facilities amounted to £16.1 billion (2009 - £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 2010, the Group had obtained funding from the Bank of England and issued debt guaranteed by the Government totalling £41.5 billion (2009 - £51.5 billion; 2008 - £32.2 billion).

Other related parties

- 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.
- 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.
- In accordance with IAS 24 transactions or balances between Group entities that have been eliminated on consolidation are not reported.
- 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.

	2010 £m	2009 £m	2008 £m
Income			
Interest receivable	89	1	569
Interest payable	907	751	885
Fees and commissions receivable	148	88	237
Fees and commissions payable	484	99	14
Expenses			
Premises and equipment	7	7	7

41 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 2010, 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 67.8% of the issued ordinary share capital of the holding company and is therefore the Group's ultimate controlling party.

42 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.

Additional information

Five year summary

Summary consolidated income statement	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Net interest income	12,111	11,543	13,509	11,116	10,392
Non-interest income (1, 2, 3)	11,593	13,000	2,348	11,191	11,176
Total income	23,704	24,543	15,857	22,307	21,568
Operating expenses (4, 5, 6, 7)	(14,475)	(12,372)	(20,367)	(11,287)	(11,341)
Profit/(loss) before impairment losses	9,229	12,171	(4,510)	11,020	10,227
Impairment losses	(9,400)	(12,174)	(4,706)	(1,865)	(1,873)
Operating (loss)/profit before tax	(171)	(3)	(9,216)	9,155	8,354
Tax (charge)/credit	(713)	523	505	(1,903)	(2,433)
(Loss)/profit for the year	(884)	520	(8,711)	7,252	5,921
(Loss)/profit attributable to:					
Non-controlling interests	29	235	208	53	45
Preference shareholders	60	523	638	331	252
Ordinary shareholders	(973)	(238)	(9,557)	6,868	5,624

Notes:

- (1) Includes gains on strategic disposals of £645 million (2009 - nil; 2008 - £442 million; 2007 and 2006 - nil).
- (2) Includes gain on redemption of own debt of £502 million (2009 - £2,694 million).
- (3) Includes fair value of own debt of £31 million loss (2009 - £298 million loss; 2008 - £920 million profit).
- (4) Includes integration and restructuring costs of £825 million (2009 - £859 million; 2008 - £647 million; 2007 - £92 million; 2006 - £120 million).
- (5) Includes purchased intangibles amortisation of £63 million (2009 - £81 million; 2008 - £100 million; 2007 - £124 million; 2006 - £94 million).
- (6) Includes write-down of goodwill and other intangible assets of £1 million (2009 - £118 million; 2008 - £8,144 million).
- (7) Includes gains on pensions curtailment of £2,148 million in 2009.

Summary consolidated balance sheet	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Loans and advances	605,826	604,610	698,890	647,795	547,042
Debt securities and equity shares	168,369	187,586	180,457	169,941	126,621
Derivatives and settlement balances	437,753	455,506	948,328	211,301	109,548
Other assets	95,382	85,279	50,255	42,701	50,416
Total assets	1,307,330	1,332,981	1,877,930	1,071,738	833,627
Owners' equity	57,010	55,051	45,958	47,683	37,936
Non-controlling interests	597	1,146	1,292	152	396
Subordinated liabilities	32,023	34,717	39,951	27,796	27,786
Deposits	557,545	569,440	635,111	594,490	516,462
Derivatives, settlement balances and short positions	470,600	468,938	955,062	256,921	152,989
Other liabilities	189,555	203,689	200,556	144,696	98,058
Total liabilities and equity	1,307,330	1,332,981	1,877,930	1,071,738	833,627

Other contractual cash obligations

The tables below summarise other contractual cash obligations by payment date.

2010	Group					
	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	110	299	723	604	1,078	1,573
Contractual obligations to purchase goods or services	69	209	105	2	—	—
	179	508	828	606	1,078	1,573

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

2010	Bank					
	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	49	122	314	281	602	1,019
Contractual obligations to purchase goods or services	63	154	99	2	—	—
	112	276	413	283	602	1,019

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

Risk factors

Set out below are certain risk factors which could have a material adverse effect on the business, operations, financial condition or prospects of the Group and cause the Group's future results to be materially different from expected results. The Group's results could also be affected by competition and other factors. The factors discussed below should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties the Group's businesses face.

RBS plc is a principal operating subsidiary of RBSG and accounts for a substantial proportion of the consolidated assets, liabilities and operating profits of RBSG. Accordingly, risk factors below which relate to RBSG and the RBS Group will also be of relevance to the Bank and the Group.

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

Under the Banking Act 2009 (the "Banking Act"), substantial powers have been granted to HM Treasury, the Bank of England and the FSA (together, the "Authorities") as part of a special resolution regime (the "SRR"). These powers enable the Authorities to deal with United Kingdom banks, building societies and other institutions with permission to accept deposits pursuant to Part IV of the FSMA (each, a "relevant entity") where the conditions set out in the next paragraph headed "The SRR may be triggered prior to the insolvency of RBS plc or RBSG" are met. The SRR consists of three stabilisation options and two insolvency and administration procedures applicable to United Kingdom banks which may be commenced by the Authorities. The stabilisation options provide for: (i) transfer of all or part of the business of the relevant entity to a private sector purchaser; (ii) transfer of all or part of the business of the relevant entity to a "bridge bank" established by the Bank of England; and (iii) temporary public ownership (nationalisation) of the relevant entity or its United Kingdom-incorporated holding company. In each case, the Authorities have been granted wide powers under the Banking Act including powers to modify contractual arrangements in certain circumstances and powers for HM Treasury to disapply or modify laws (with possible retrospective effect) to enable the powers under the Banking Act to be used effectively. The following paragraphs of this risk factor headed "RBSG and its United Kingdom bank subsidiaries may face the risk of full nationalisation or other resolution procedures under the Banking Act 2009" set out some of the possible consequences of the exercise of those powers under the SRR.

The SRR may be triggered prior to the insolvency of RBS plc or RBSG

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 (a) the FSA is satisfied that a relevant entity (such as RBS plc) is failing, or is likely to fail, to satisfy the threshold conditions within the meaning of section 41(1) of the FSMA (which are the conditions that a relevant entity must satisfy in order to retain its authorisation to perform regulated activities), (b) following consultation with the other Authorities, the FSA determines that 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, and (c) the Authorities consider the exercise of the stabilisation options to be necessary, having regard to certain public interest considerations (such

as the stability of the United Kingdom financial systems, public confidence in the United Kingdom banking systems and the protection of depositors). It is therefore possible that one of the stabilisation options could be exercised prior to the point at which any insolvency proceedings with respect to the relevant entity (such as RBS plc or NatWest) could be initiated.

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 RBSG) into temporary public ownership provided that certain conditions 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.

Various actions may be taken in relation to any securities issued by RBS plc without the consent of the holders thereof

If the stabilisation options are exercised in respect of RBS plc, HM Treasury or the Bank of England may exercise extensive share transfer powers (applying to a wide range of securities) and property transfer powers (including powers for partial transfers of property, rights and liabilities) in relation to RBS plc. Exercise of these powers could involve taking various actions in relation to any securities issued by RBS plc (the "Securities") without the consent of holders of the Securities, including (among other things):

- (i) transferring the Securities free from any contractual, legislative or other restrictions on transfer;
- (ii) transferring the Securities free from any trust, liability or other encumbrance;
- (iii) extinguishing any rights to acquire Securities;
- (iv) delisting the Securities;
- (v) converting the Securities into another form or class (the scope of which power is unclear, although may include, for example, conversion of the Securities into equity securities);
- (vi) disapplying any termination or acceleration rights or events of default under the terms of the Securities which would be triggered by the transfer or certain related events; or
- (vii) where property is held on trust, removing or altering the terms of such trust.

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.

The taking of any such actions may adversely affect the rights of holders of the Securities, the price or value of their investment in the Securities and/or the ability of RBS plc to satisfy its obligations under the Securities and/or contracts related to the Securities. Where the transfer powers are effected, HM Treasury is required to make certain compensation or resolution fund orders and holders of Securities may have a claim for compensation under one of the compensation schemes contemplated by the Banking Act if any action is taken in respect of the Securities (and if the relevant order provides for the amount of compensation payable to be determined by an independent valuer, then for the purposes of determining an amount of compensation, the independent valuer must disregard actual or potential financial assistance provided by the Bank of England or HM Treasury). However, there can be no assurance that compensation would be assessed to be payable or that holders of the Securities would recover any compensation promptly and/or equal to any loss actually incurred.

Contractual arrangements between RBS plc, other companies within the RBS Group and/or the bridge bank or private sector purchaser may be created, modified or cancelled

If RBSG were taken into temporary public ownership and a partial transfer of its or any relevant entity's (including RBS plc's) business were effected, or if a relevant entity (such as RBS plc) were made subject to the SRR and a partial transfer of its business to another entity were effected, the transfer may directly affect RBS plc and/or the other Group companies by creating, modifying or cancelling its or 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 RBS plc or other Group companies to support and co-operate with the bridge bank or private sector purchaser; (ii) cancel or modify contracts or arrangements between RBS plc or the transferred business and a Group company; or (iii) impose additional obligations on RBS plc under new or existing contracts. There can be no assurance that the taking of any such actions would not adversely affect the ability of RBS plc to satisfy its obligations under the issued Securities or related contracts.

A partial transfer of RBS plc's business may result in a deterioration of its creditworthiness

If RBSG were taken into temporary public ownership and a partial transfer of its or any relevant entity's business were effected, or if a relevant entity (such as RBS plc) 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 RBS plc's financial condition and increase the risk that RBS plc may eventually become subject to administration or insolvency proceedings pursuant to the Banking Act. In such circumstances, holders of Securities may have a claim for compensation under one of the compensation schemes contemplated by the Banking Act, but there can be no assurance that compensation would be assessed to be payable or that such holders would recover any compensation promptly and/or equal to any loss actually incurred.

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 partial nationalisation. There have been concerns in the market in recent years regarding the risks of such nationalisation in relation to RBS plc 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 were to occur to such an extent that they had 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 Group or the RBS Group, the United Kingdom Government may decide to take similar action in relation to RBS plc under the Banking Act. Given the extent of the Authorities' powers under the Banking Act, it is difficult to predict the effect that such actions might have on RBS plc or the Group and any securities issued by RBS plc or Group companies. However, potential impacts may include full nationalisation of RBSG or RBS plc, the total loss of value in Securities issued by RBS plc and the inability of RBS plc to perform its obligations under the Securities.

If a relevant stabilisation option were effected in respect of RBSG or the stabilisation options were effected in respect of a relevant entity (such as RBS plc) or its business within the RBS Group, HM Treasury would be required to make certain compensation or resolution fund orders, which would 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 the 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 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 which are the RBS Group's customers and counterparties in the ordinary course of its business. In response to this economic instability and market illiquidity, a number of governments, including the United Kingdom Government, the governments of the other EU member states and the United States Government intervened in order to inject liquidity and capital into the financial system, and in some cases, to prevent the failure of these institutions.

Risk factors *continued*

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 in the near to medium term. 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 of credit for financial institutions and upward pressure on the cost of credit for financial institutions, including RBSG, RBS plc, RBS Holdings N.V. and The Royal Bank of Scotland N.V. ("RBS N.V."), 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 prices of RBSG's Ordinary Shares, decreased asset values, additional write-downs and impairment charges and lower profitability.

In particular, the performance of the RBS Group may be affected by economic conditions impacting EU member states. For example, the financial problems recently experienced by the governments of certain EU member states (including Greece and Ireland) may lead to the issuance of significant volumes of debt by such member states and European Union entities, which may in turn reduce demand for debt issued by financial institutions and corporate borrowers. This, as well as credit rating downgrades experienced by such member states, could adversely affect the RBS Group's access to the debt capital markets and may increase the RBS Group's funding costs, which could have a material adverse impact on the RBS Group's earnings, cash flow and financial condition. In addition, EU member states in which the RBS Group operates have agreed to provide financial assistance to certain member states, currently Greece and Ireland, and may be required to provide financial assistance to other EU member states in the future, which may in turn have a negative impact on the financial condition of those EU member states providing the assistance. The RBS Group's exposure to the economies of such member states, in particular Ireland, has resulted in the RBS Group making significant provisions. Should the adverse economic conditions currently faced by such member states be replicated in other EU member states, the risks discussed above would be exacerbated.

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 is

currently exposed to country concentration risk in the United States, the United Kingdom and the rest of Europe and certain business sector concentration risk 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 is subject to a variety of risks as a result of implementing the State Aid restructuring plan and is prohibited from making discretionary dividend or coupon payments on existing hybrid capital instruments (including preference shares and B Shares) which may impair the RBS Group's ability to raise new Tier 1 capital

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 placing and open offer undertaken by RBSG in December 2008 (the "First Placing and Open Offer"), the issuance of £25.5 billion of B shares in the capital of RBSG (the "B Shares") which are, subject to certain terms and conditions, convertible into ordinary shares in the share capital of RBSG ("Ordinary Shares") to HM Treasury, a contingent commitment by HM Treasury to subscribe (the "Contingent Subscription") for up to an additional £8 billion of B Shares (the "Contingent B Shares") if certain conditions are met and the RBS Group's participation in the Asset Protection Scheme (the "APS") (the "State Aid").

In that context, as part of the terms of the State Aid approval, the RBS Group, together with HM Treasury, agreed the terms of a restructuring plan (the "State Aid restructuring plan").

As part of the State Aid restructuring plan, there is a 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 which commenced on 30 April 2010. These restrictions will prevent RBSG, RBS plc and other RBS Group companies (other than companies in the RBS Holdings N.V. group (which was renamed from ABN AMRO Holding N.V. on 1 April 2010), which are subject to different restrictions) from paying dividends on their preference shares and coupons on other Tier 1 securities, and RBSG from paying dividends on its Ordinary Shares, for the same duration, and it may impair the RBS Group's ability to raise new capital through the issuance of Ordinary Shares of RBSG and other securities issued by RBS plc.

The RBS Group is subject to a variety of risks as a result of implementing the State Aid restructuring plan, including required asset disposals. In particular, 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, the RBS Group's insurance division (subject to potentially maintaining a minority interest until the end of 2014). RBSG also agreed to divest its global card payment services business, Global Merchant Services ("GMS"), by the end of 2013, subject to RBSG retaining up to 20 per cent of GMS if required by the purchaser, its interest in RBS Sempra Commodities LLP ("RBS Sempra Commodities"), the RBS Group's joint venture with Sempra Energy and a leading global commodities trader and the RBS branch-based business in England and Wales and the NatWest branches in Scotland, along with the Direct small and medium-size enterprise ("SME") customers and certain mid-corporate customers across the United Kingdom. The RBS Group has progressed with certain of these disposals over the course of 2010. There is no assurance that the price that the RBS Group receives or has received 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 contained in the terms thereof. Further, if the RBS Group fails to complete any of the required disposals within the agreed timeframes for such disposals, under the terms of the State Aid approval, a divestiture trustee may 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 any such investigation, if the European Commission decided that there had been misuse of aid, it could 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 employees 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 existing 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 adverse 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 its balance sheet reduction programme

In light of the changed global economic outlook, the RBS Group is engaged in 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 businesses and the continued review of the RBS Group's portfolio to identify further disposals of certain non-core assets and businesses. 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 2010, this total had reduced to £137.9 billion, excluding derivatives, largely as a result of the progress made in business disposals and portfolio sales during the course of 2010. This balance sheet reduction programme continues 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 remaining businesses it is seeking to exit either on favourable economic terms to the RBS Group or at all. Tax liabilities could arise on the disposal of assets. 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.

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.

Risk factors *continued*

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 noted above in the context of the State Aid restructuring plan and in the context of other 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 could negatively affect the Group's ability to implement its strategic plan and have a material adverse effect on the Group's business, results of operations, financial condition, capital ratios and liquidity and 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 wholesale 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 recent years, credit markets worldwide have experienced a severe reduction in liquidity and term-funding. During this time, the market perception of bank credit risk has changed significantly and banks that are deemed by the market to be riskier have issued debt at a premium to the cost of debt for banks that are perceived by the market as being safer. The uncertainty regarding the perception of credit risk across different banking groups 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 again be, restricted. In addition, in common with other banking groups, the RBS Group has experienced pressures to increase the average maturity of its wholesale funding. An increase in the maturity of wholesale funding has the effect of increasing the RBS Group's overall cost of funding.

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 recent periods of liquidity stress has been constrained to the point where it, in common with many other banking groups, 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 money market conditions improved during the course of 2009 and 2010, 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 materially adverse impact on the RBS Group and the Group. The RBS Group, in common with other banking groups, may need to seek funds from alternative sources and potentially at higher costs than has previously been the case.

In addition, there is also a risk that corporate and financial institution counterparties with credit exposures may seek to reduce their 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 for retail customer deposits 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 materially adverse impact on the 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. Significant progress was made during the course of 2010 in reducing non-core asset levels. While the liquidity position of the Group may be materially adversely impacted if it is unable to achieve the run-off and sale of non-core and other assets and businesses as expected, the magnitude of this risk reduced during the course of 2010. Any significant delay in those plans may nevertheless require the RBS Group to consider disposals of other assets not previously identified for disposal to achieve its funded balance sheet target level.

The Group has participated in governmental support schemes including the United Kingdom Government Credit Guarantee Scheme and the Special Liquidity Scheme. The Credit Guarantee Scheme closed for new issuance in February 2010 and the Special Liquidity Scheme closed for new transactions in January 2009. All of the Group's financing under the United Kingdom Government Credit Guarantee Scheme and the Special Liquidity Scheme matures in 2011 and 2012. As at 31 December 2010, the total amount outstanding of debt instruments issued by RBS plc which benefit from the United Kingdom Government Credit Guarantee Scheme was £41,455 million. For further information, see the sections of the 2010 Annual Report and Accounts of RBSG headed "Risk and balance sheet management - Balance sheet management: Funding and liquidity risk - Credit Guarantee Scheme" and "Risk and balance sheet management - Balance sheet management: Funding and liquidity risk - Special Liquidity Scheme". The Group expects to mitigate the impact of this refinancing concentration through a combination of seeking funds from alternative sources, the continuation of the Group's balance sheet reduction programme and other reductions in the Group's net wholesale funding requirement. However, there can be no assurance that such mitigation efforts will be successful.

There can be no assurance that the measures described above, 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 or require the RBS Group to consider disposals of other assets not previously identified for disposal to reduce its funding requirements, each of which could have a material adverse impact on the RBS Group's financial condition and results of operations or result in a loss of value in the Securities.

The financial performance of the RBS Group has been materially affected by deteriorations in borrower credit quality and it may continue to be impacted by any further deteriorations, including as a result of prevailing economic and market conditions, and legal and regulatory developments. 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 the last two years, 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 debts, with increasing delinquencies, defaults and insolvencies across a range of sectors (such as the personal and financial institution sectors) and in a number of geographies (such as the United Kingdom, the United States and the rest of Europe, particularly Ireland). The credit quality of the RBS Group's borrowers and counterparties is impacted by prevailing economic and market conditions, as well as by the legal and regulatory landscape in their respective markets, and if there is a further deterioration in economic and market conditions in one or more markets in which the RBS Group operates or there are changes to the legal or regulatory landscapes in such markets, this could worsen the credit quality of the RBS Group's borrowers and counterparties and also impact the RBS Group's ability to enforce contractual security rights.

In the United States during the last year there has been disruption in the ability of certain financial institutions to complete foreclosure proceedings in a timely manner (or at all), including as a result of interventions by certain states and local governments. This disruption has lengthened the time to complete foreclosures, increased the backlog of repossessed properties and, in certain cases, has resulted in the invalidation of purported foreclosures. In addition, a number of other financial institutions have experienced increased repurchase demands in respect of US mortgage loans or other related securities originated and sold. However, the RBS Group has not experienced a significant volume of repurchase demands in respect of similar loans or related securities it originated or sold and has not ceased any of its US foreclosure activities. The trends and risks affecting borrower credit quality have caused, and in the future may cause, the RBS Group to experience further and accelerated impairment charges, increased repurchase demands, higher costs, additional write-downs and losses for the RBS Group, including the Group, and may 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 institutions, sovereign counterparties or the financial services industry generally, have led to market-wide liquidity problems, losses and defaults and could lead to further losses being incurred by the RBS Group or by other institutions. Many of these transactions expose the RBS Group to credit risk in the event of default by 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 geographic markets, particularly the United States and Europe). 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 experienced in recent years. Any such losses could have an adverse effect on the 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, materially 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 recent years. 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, including the Group, to recognise further significant write-downs in addition to those already recorded or realised or realise increased impairment charges, which may have a material adverse effect on its financial condition and its results of operations or result in a loss of value in the Securities.

Risk factors *continued*

Further information about the write-downs which the RBS Group has incurred and the assets it has reclassified during the year ended 31 December 2010 is set out in the Risk and balance sheet management section of the Business review within The Royal Bank of Scotland Group plc Annual Report and Accounts 2010.

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 and the 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 Group's financial condition and results of operations.

Changes in interest rates, foreign exchange rates, credit spreads, bond, equity and commodity prices, basis, volatility and correlation risks and other market factors have significantly affected and will continue to affect the RBS Group's business and results of operations

Some of the most significant market risks the RBS Group faces are interest rate, foreign exchange, credit spread, bond, equity and commodity price and basis, volatility and correlation 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 recent years. 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 RBSG's non-United Kingdom subsidiaries (principally Citizens Financial Group, Inc. ("Citizens"), RBS N.V. and RBS Securities Inc.) and may affect income from foreign exchange dealing. RBS plc prepares its consolidated financial statements in sterling. Fluctuations in the exchange rates used to translate other currencies into sterling affect RBS plc's reported consolidated financial condition, results of operations and cash flows from year to year and those of the Group's operations whose functional currency is not sterling. The performance of financial markets may affect bond, equity and commodity prices and, therefore, cause changes in the value of the 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 variations in the value of such portfolios. As part of its ongoing derivatives operations, the Group also faces significant basis, volatility and correlation risks for which materialisation is highly

dependent on relative changes in the first order risks referred to above. While the 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 Group's financial performance and business operations.

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

RBSG, RBS plc and other RBS Group members have been subject to a number of credit rating downgrades in the recent past. Any future reductions in the long-term or short-term credit ratings of RBS plc or one of its principal subsidiaries would further increase its borrowing costs, require the RBS Group, including the 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 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 materially adversely affect the credit ratings of Group companies and may have the effects noted above. Standard & Poor's Credit Market Services Europe Limited reaffirmed the United Kingdom Government's "AAA" rating with stable outlook on 26 October 2010 and Moody's Investors Service Limited reaffirmed the United Kingdom Government's "Aaa" rating on 7 May 2010. Fitch Ratings Limited reaffirmed the United Kingdom Government's "AAA" rating with stable outlook on 31 July 2009 and Moody's Investors Service Limited reiterated the United Kingdom Government's stable outlook on 23 June 2010. Credit ratings of RBSG, RBS plc, RBS N.V., Ulster Bank and Citizens are also important to the Group when competing in certain markets, such as over-the-counter derivatives. As a result, any further reductions in RBSG's long-term or short-term credit ratings or those of its principal subsidiaries could adversely affect the Group's access to liquidity and competitive position, increase its funding costs and have a material adverse impact on the Group's earnings, cash flow 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 as a result of 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 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 liquidity policy statement issued in October 2009 states that UK regulated firms must hold sufficient eligible securities to survive a liquidity stress and that liquidity policy statement, together with the developments described below, has resulted in the RBS Group holding a greater amount of government securities to ensure that it has adequate liquidity in times of financial stress.

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". On 12 September 2010, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee, announced further details of the proposed substantial strengthening of existing capital requirements, and the reforms were endorsed by the G-20 leaders after the G-20 Summit in Seoul in November 2010. On 16 December 2010, the Basel Committee published the Basel III rules in documents entitled "Basel III: A global regulatory framework for more resilient banks and banking systems" (containing the reforms relating to capital) and "Basel III: International framework for liquidity risk measurement, standards and monitoring" (containing the reforms relating to liquidity).

The Basel Committee's package of reforms includes increasing the minimum common equity requirement from 2 per cent (before the application of regulatory adjustments) to 4.5 per cent (after the application of stricter regulatory adjustments). The total Tier 1 capital requirement, which includes common equity and other qualifying financial instruments, will increase from 4 per cent to 6 per cent. The total capital requirement (which comprises Tier 1 capital and Tier 2 capital) remains at 8 per cent. In addition, banks will be required to maintain, in the form of common equity (after the application of deductions), a capital conservation buffer of 2.5 per cent to withstand future periods of stress, bringing the total common equity requirements to 7 per cent. If there is excess credit growth in any given country resulting in a system-wide build up of risk, a countercyclical buffer within a range of 0 per cent to 2.5 per cent of common equity (or possibly other fully loss absorbing capital) is to be applied as an extension of the conservation buffer. In addition, a leverage ratio will be introduced, together with a liquidity coverage ratio and a net stable funding ratio. The liquidity coverage ratio is intended to promote resilience to potential liquidity stress scenarios lasting for a 30-day period. The net stable funding ratio is intended to limit over reliance on short-term wholesale funding and has been developed to provide a sustainable maturity structure of assets and liabilities. The Basel Committee is conducting further work on systemically important financial institutions and contingent capital in close coordination with the Financial Stability Board. The Basel Committee has stated that measures may include capital surcharges, contingent capital and bail-in debt (which could be introduced by statute, possibly impacting existing as well as future issues of debt and exposing them to the risk of conversion into equity and/or write-down of principal amount). Such measures would be in addition to proposals for the write-off of Tier 1 and Tier 2 debt (and its possible conversion into ordinary shares) if a bank becomes non-viable. The Basel Committee is expected to complete by early to mid 2011 a methodology for identifying global systemically important financial institutions with a view to the Financial Stability Board and national

authorities determining by mid-2011 those institutions to which the recommendations for global systemically important financial institutions will initially apply. In addition, by mid-2011, the Basel Committee is to complete a study of how much additional loss absorbency capacity global systemically important financial institutions should have and how much of such capacity could be provided by the various proposed instruments (which include contingent capital securities and bail-in debt).

The implementation of the Basel III reforms will begin on 1 January 2013, however the requirements are subject to a series of transitional arrangements and will be phased in over a period of time, to be fully effective by 2019.

To the extent the RBS Group has estimated the indicative impact that Basel III reforms may have on its risk-weighted assets and capital ratios, such estimates are preliminary and subject to uncertainties and may change. In particular, the estimates assume mitigating actions will be taken by the RBS Group (such as deleveraging of legacy positions and securitisations, including non-core, as well as other actions being taken to derisk market and counterparty exposures), which may not occur as anticipated, in a timely manner, or at all.

The Basel Committee changes and other future changes to capital adequacy and liquidity requirements in the United Kingdom and in other jurisdictions in which it operates, including the European Commission's public consultation on further possible changes to the Capital Requirements Directive launched in February 2010, may require the RBS Group to raise additional Tier 1 (including 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 will 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 RBSG and its shareholders, including impairing RBSG's ability to pay dividends on or make other distributions in respect of Ordinary Shares and diluting the ownership of existing shareholders of RBSG. 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 disposal 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 (as defined below), the RBS Group will 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.

Additional information *continued*

Risk factors *continued*

As at 31 December 2010, the Group's Tier 1 and Core Tier 1 capital ratios were 10.1 per cent and 8.4 per cent, respectively, calculated in accordance with FSA requirements. Any change that limits the 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 International Financial Reporting Standards ("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 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 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 material adverse effect on the 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

The consolidation that has taken place in recent years among banking institutions in the United Kingdom, the United States and throughout Europe continues to change 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 attract 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 key employees, which may have a negative impact on the 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. The effects of the substantial government shareholding and involvement in banks may differ from jurisdiction to jurisdiction, and such involvement may cause the 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 Group's business, margins, profitability, financial condition and prospects or result in a loss of value in the Securities.

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 an adverse impact on the Group's business. The 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 and employee compensation arrangements, in particular those in receipt of Government funding (such as the RBS Group). In connection with its accession to the APS, the RBS Group agreed with HM Treasury that it will be at the leading edge of implementing the G-20 principles and to consult with UK Financial Investments Limited ("UKFI") in connection with the RBS Group's remuneration policy and the RBS Group made a commitment to HM Treasury to comply with the FSA Remuneration Code which came into force on 1 January 2010. On 1 January 2011, a revised FSA Remuneration Code came into effect to implement the requirements of the Capital Requirements Directive III.

In addition, as a result of its accession to the APS, the RBS Group also has reached agreement with HM Treasury in relation to remuneration arrangements for the executive directors of the RBS Group and certain employees involved in the APS, including approval rights for the Asset Protection Agency on annual APS-related performance targets. 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 Group's businesses.

In recent years, the RBS Group has altered certain of the pension benefits it offers to staff and 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 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 Group at a significant competitive disadvantage and prevent the Group from successfully implementing its strategy, which could have a material adverse effect on the 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 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 restructuring plans), it faces increased risk in this regard and there can be no assurance that the Group will be able to maintain good relations with its employees or employee representative bodies in respect of all matters. As a result, the Group may experience strikes or other industrial action from time to time, which could have an 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. Significant regulatory developments could have an adverse 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 jurisdiction in which it operates. All of these are subject to change, particularly in the current regulatory and market environment, where there have been unprecedented levels of government intervention, changes to the regulations governing financial institutions and reviews of the industry, including nationalisations or injections of government capital in the United States, the United Kingdom and other European countries. In recent years, there has also been increasing focus in the United Kingdom, United States and other jurisdictions in which the RBS Group operates on compliance with anti-bribery, anti-money laundering, anti-terrorism and other similar sanctions regimes. As a result of the environment in which the RBS Group operates, increasing regulatory focus in certain areas and 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 and scrutiny in the United Kingdom, the United States and other countries in which it operates.

Although it is difficult to predict with certainty the effect that recent regulatory developments and heightened levels of public and regulatory scrutiny will have on the RBS Group, the enactment of legislation and

regulations in the United Kingdom, the other parts of Europe in which the RBS Group operates and the United States (such as the bank levy in the United Kingdom or the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States) is likely to result in increased capital and liquidity requirements and changes in regulatory requirements relating to the calculation of capital and liquidity metrics or other prudential rules relating to capital adequacy frameworks, and may result in an increased number of regulatory investigations and actions. Any of these developments could have an adverse impact on how the Group conducts its business, applicable authorisations and licences, the products and services it offers, its reputation, the value of its assets, its funding costs and its results of operations and financial condition or result in a loss of value in the Securities.

Areas in which, and examples of where, governmental policies, regulatory changes and increased public and regulatory scrutiny could have an adverse impact on the RBS Group include, but are not limited to:

- the monetary, fiscal, interest rate and other policies of central banks and other governmental or regulatory bodies;
- requirements to separate retail banking from investment banking, and restrictions on proprietary trading and similar activities within a commercial bank and/or a group which contains a commercial bank;
- government-imposed requirements with respect to lending to the United Kingdom SME market and larger commercial and corporate markets and residential mortgage lending;
- requirements to operate in a way that prioritises objectives other than shareholder value creation;
- changes to financial reporting standards (including accounting standards), corporate governance requirements, corporate structures and conduct of business rules;
- the imposition of restrictions on the RBS Group's ability to compensate its senior management and other employees;
- regulations relating to, and enforcement of, anti-bribery, anti-money laundering, anti-terrorism or other similar sanctions regimes;
- rules relating to foreign ownership, expropriation, nationalisation and confiscation of assets;
- other requirements or policies affecting the RBS Group's profitability, such as the imposition of onerous compliance obligations, further restrictions on business growth or pricing and the introduction of, and changes to, levies, fees or taxes applicable to the RBS Group's operations (such as the imposition of financial activities taxes and changes in tax rates that reduce the value of deferred tax assets); 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.

For further information on the Bank levy in the United Kingdom, see Note 31 on page 219.

Risk factors *continued*

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, anti-money laundering charges and sanctions, compliance investigations 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 in recent years 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 early stages of a case or investigation. Adverse regulatory action or adverse judgments in litigation could result in restrictions or limitations on the Group's operations or have a significant effect on the 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 31 on pages 219 to 223.

The RBS Group's results have been and could be further materially 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 the 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 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. For the year ended 31 December 2008, the RBS Group recorded a £32.6 billion accounting write-down of goodwill and other intangibles relating to prior year acquisitions. For the year ended 31 December 2009, the RBS Group recorded a £363 million accounting write-down of goodwill and other intangible assets principally relating to RBS Holdings N.V. (formerly ABN AMRO Holding N.V.) and NatWest goodwill allocated to Non-Core businesses. For the year ended 31 December 2010, the RBS Group recorded a £10 million accounting write-down of goodwill and other intangible assets.

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 assets of the RBS Group's various defined benefit pension schemes

which are long term in nature do not fully match the timing and amount of the schemes' liabilities, as a result of which the RBS Group is required or chooses to make additional contributions to the schemes. Pension scheme liabilities vary with changes to long-term interest rates, inflation, pensionable salaries and the longevity of scheme members as well as changes in applicable legislation. 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, returns from them and any additional future contributions to the schemes 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 to the schemes. Given the recent 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 an adverse impact on the RBS Group's results of operations or financial condition or result in a loss of value in the Securities. A funding valuation of the RBS Group's major defined benefit pension plan, The Royal Bank of Scotland Group Pension Fund, is currently being carried out with an effective date of 31 March 2010.

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-bribery, anti-money laundering and anti-terrorism legislation, as well as the provisions of applicable sanctions programmes), equipment failures, business continuity and data security system 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 such laws or regulations, could result in increased regulatory supervision, enforcement actions and other disciplinary action, and have an adverse impact on the Group's business, applicable authorisations and licences, reputation, results of operations and the price of the Securities. Notwithstanding anything contained in this risk factor, it should not be taken as implying that RBS plc will be unable to comply with its obligations as a company with securities admitted to the Official List of the United Kingdom Listing Authority (the "Official List") 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 Group would reduce the Group's profitability. Revisions to tax legislation or to its interpretation might also affect the Group's results in the future. From January 2011, the United Kingdom Government increased the standard rate of value added tax from 17.5 per cent to 20 per cent and on 1 January 2011, the United Kingdom Government introduced the banking levy. These changes, together with any future changes, such as the possible introduction of a financial activities tax, could reduce the Group's profitability.

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 RBSG. 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 RBSG for the benefit of its members as a whole.

The offer or sale by the United Kingdom Government of all or a portion of its stake in RBSG could affect the market price of the Securities and related securities

The United Kingdom Government currently holds approximately 68 per cent of the issued ordinary share capital of RBSG. On 22 December 2009, RBSG issued £25.5 billion of B Shares to the United Kingdom Government. The B Shares are convertible, at the option of the holder at any time, into Ordinary Shares. The United Kingdom Government has agreed that it shall not exercise the rights of conversion in respect of the B Shares if and to the extent that following any such conversion it would hold more than 75 per cent of the total issued shares in RBSG. The United Kingdom Government may sell all or a part of the Ordinary Shares

that it owns at any time. Offers or sales by the United Kingdom Government of a substantial number of Ordinary Shares or securities convertible or exchangeable into Ordinary Shares, or an expectation that it may undertake such an offer or sale, could affect prevailing market prices for the Securities and related securities.

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 Group's ability to keep and attract customers and, in particular, corporate and retail depositors. The 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 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 Group may have an adverse impact on its results of operations and financial condition. As at 31 December 2010, the RBS Group had accrued £144 million for its share of Compensation Scheme management expenses levies for the 2010/2011 and 2011/2012 Compensation Scheme years (as set out in the 2010 Annual Results of RBSG).

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 Group may make further provisions and may incur additional costs and liabilities, which may have an adverse impact on its financial condition and results of operations or result in a loss of value in the Securities.

Risk factors *continued*

The RBS Group's business and earnings may be adversely 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 Group's business.

The restructuring plan for RBS Holdings N.V. is complex and may not realise the anticipated benefits for the RBS Group

In 2007, the RBS Group acquired an interest, through RFS Holdings B.V., in ABN AMRO Holding N.V. (which was renamed RBS Holdings N.V. on 1 April 2010). The restructuring plan in place for the integration and separation of ABN AMRO Holding N.V. into and among the businesses and operations of the Consortium Members is complex, involving substantial reorganisation of RBS Holdings N.V.'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 majority of the businesses of RBS Holdings N.V. acquired by the Dutch State were legally demerged from the RBS Holdings N.V. businesses acquired by the RBS Group and were transferred into a newly established company, ABN AMRO Bank N.V. (formerly named ABN AMRO II N.V.). This company was transferred to ABN AMRO Group N.V., a company wholly owned by the Dutch State, on 1 April 2010. Certain assets and liabilities of RBS Holdings N.V. acquired by the Dutch State were not part of the transfer which occurred on 1 April 2010 and remain within ABN AMRO Bank N.V. (now The Royal Bank of Scotland N.V.). These will be transferred to the Dutch State as soon as possible. In addition, certain assets within RBS N.V. continue to be under shared ownership by the Consortium Members.

On 31 December 2010, the share capital of RFS Holdings B.V. was amended, such that approximately 98 per cent of RFS Holdings B.V.'s issued share capital is now held by RBSG, with the remainder being held by Santander and the Dutch State. Ultimately it is expected that RFS Holdings B.V. will become a wholly-owned subsidiary of RBSG.

As the RBS Group does not currently own 100 per cent of RFS Holdings B.V. and as certain of the assets of RFS Holdings B.V. are owned indirectly by the Dutch State and Banco Santander S.A. ("Santander"), the RBS Group may experience delays in implementing the planned integration of the businesses of RFS Holdings B.V. which are owned by the RBS Group and such integration may place a strain on management, employee, operational and financial resources. Any such delays may also restrict the ability of the RBS Group to realise the expected benefits of the acquisition. In addition, the RBS Group may not realise the benefits of the acquisition or the restructuring when expected or to the extent projected. Any of these events may have an adverse impact on the RBS Group's financial condition and results of operations.

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. In April 2011, the United Kingdom Government will commence a staged reduction in the rate of United Kingdom corporation tax from 28 per cent to 23 per cent over a four-year period. Such a change in the applicable tax rate would 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 capital 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 16 December 2010, the Basel Committee published the Basel III rules setting out certain changes to capital requirements (see the risk factor above headed "The RBS Group's business performance could be adversely affected if its capital is not managed effectively or as a result of changes to capital adequacy and liquidity requirements"). Those rules include a requirement that deferred tax assets which rely on future profitability of the RBS Group to be realised may only receive limited recognition when calculating the common equity component of Tier 1 which therefore limits the amount of deferred tax assets which can count towards that component of Tier 1 capital. The implementation of the Basel III reforms will begin on 1 January 2013, however the restrictions on recognition of deferred tax assets within the common equity component of Tier 1 are subject to a phased-in deduction starting on 1 January 2014, to be fully effective by 1 January 2018.

RBS plc has entered into a credit derivative and a financial guarantee contract with RBS N.V. which may adversely affect the Group's results

RBS plc has entered into a credit derivative and a financial guarantee contract with RBS N.V., which is a subsidiary of RBSG, under which it has sold credit protection over the exposures held by RBS N.V. and its subsidiaries that are subject to the APS. These agreements may adversely affect the Group's results as: (a) they cover 100 per cent of losses on these assets whilst the APS provides 90 per cent protection if 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".

The RBS Group's participation in the APS is costly and may not produce the benefits expected and the occurrence of associated risks may have a material adverse impact on the RBS Group's business, capital position, financial condition and results of operations

On 22 December 2009, the RBS Group acceded to the APS with HM Treasury acting on behalf of the United Kingdom Government. Under the APS, the RBS Group purchased credit protection over a portfolio of specified assets and exposures of RBS plc and certain members of the RBS Group from HM Treasury in return for an annual fee. If losses on assets covered by the APS exceed £60 billion (net of recoveries), HM Treasury will bear 90 per cent of further losses. In the event of a further severe or prolonged economic downturn, which could result in extreme credit losses on the RBS Group's asset portfolio, the APS provides additional protection to the RBS Group's capital ratios and financial position.

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.

Owing to the complexity, scale and unique nature of the APS and the uncertainty resulting from 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. 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 certain predictions and assumptions at the time of its accession to the APS. 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 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.

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 of Contingent B Shares, the RBS Group remains exposed to a substantial first loss amount of £60 billion (net of recoveries) in respect of the Covered Assets and for 10 per cent of Covered Assets losses after the

first loss amount. There is therefore no assurance that the RBS Group's participation in the APS and the issue of B Shares and, if required, the 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 and improving market confidence in the RBS Group. 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. 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 the 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. In that case, any compensation payable to holders of the Securities would be subject to the provisions of the Banking Act, and investors may receive no value for their Securities.

If the RBS Group is unable to issue the Contingent B Shares to HM Treasury, it may have a material adverse impact on the RBS Group's capital position, liquidity, operating results and future prospects

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 are not waived by HM Treasury, and RBSG is unable to issue the Contingent B Shares, the RBS Group 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 RBSG is unable to issue the 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 the Securities to decline substantially and may result in intervention by the Authorities or other regulatory bodies in the other jurisdictions in which the RBS Group operates, 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.

Risk factors *continued*

There are limits on APS coverage and uncovered exposures and risks may have a material adverse impact on the RBS Group's business, financial condition, capital position, liquidity and results of operations

As a result of the significant volume, variety and complexity of assets and exposures and the resulting complexity of the APS documents, there is a risk that the RBS Group may have included assets or exposures within the Covered Assets which are, or may later become, ineligible for protection under the APS, which would reduce the anticipated benefits to the RBS Group of the APS. Further, there is no ability to nominate additional or alternative assets or exposures in place of any which may turn out not to be covered under the APS.

Protection under the APS may be limited or may cease to be available where (i) Covered Assets are not correctly or sufficiently logged or described, (ii) a Covered Asset is disposed of (in whole or in part) prior to a trigger event, (iii) the terms of the APS do not apply or are uncertain in their application, (iv) the terms of the protection itself potentially give rise to legal uncertainty, (v) certain criminal conduct has or may have occurred in respect of Covered Assets, (vi) a breach of bank secrecy, confidentiality, data protection or similar laws has occurred or may occur, (vii) certain of the extensive governance, asset management, audit and reporting obligations under the UK Asset Protection Scheme Terms and Conditions (the "Scheme Conditions") are not complied with, (viii) the RBS Group does not comply with the instructions of a step-in manager appointed by HM Treasury or (ix) HM Treasury seeks to appoint a step-in manager in respect of Covered Assets held within the RBS Holdings N.V. group (or in certain other jurisdictions) and it is not possible to obtain consent from the Dutch Central Bank (if required) to such step-in.

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 governance, asset management, audit and reporting obligations under the Scheme Conditions. The RBS Group's compliance with the Scheme Conditions is dependent on its ability to (i) implement efficiently and accurately 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. 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. Where the RBS Group is in breach of its continuing obligations under the Scheme Conditions or otherwise unable to provide or verify information as required under the APS, 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. The occurrence of the risks or circumstances referred to above may 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, 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 the 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 extensive governance, asset management and information requirements under the Scheme Conditions and any changes or modifications to the Scheme Conditions may have a negative impact on the expected benefits of the APS and may have an adverse impact on the RBS Group

There are extensive governance, asset management and information requirements under the Scheme Conditions in relation to the Covered Assets, other assets and the operations of the RBS Group and HM Treasury also has the right to require the appointment of one or more step-in managers to exercise certain step-in rights in certain circumstances. 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. Additionally pursuant to the accession agreement between HM Treasury and RBSG relating to the accession to the APS (the "Accession Agreement"), HM Treasury has the right to require RBS plc to appoint one or more Special Advisers ("SOC Special Advisers") to exercise oversight functions over certain assets in the APS. On 18 June 2010, the Asset Protection Agency required that RBS plc appoint SOC Special Advisers in relation to certain assets and business areas in order to provide additional support to the Senior Oversight Committee of RBS plc and there have been four such appointments to date granting certain oversight rights in relation to certain specified assets. 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. In addition, the market's reaction to such controls and limitations may have an adverse impact on the price of the Securities. 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) in certain circumstances. Such modifications or replacements may be retrospective and may result in (i) a loss of or reduction in the protection expected by the RBS Group under the APS, (ii) an increase in the risk weightings of the Covered Assets, (iii) a material increase in the continuing reporting obligations or asset management conditions applicable to the RBS Group under the Scheme Conditions, (iv) a material increase in the costs of the APS and/or (v) 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.

Any changes to the expected regulatory capital treatment of the APS, the B Shares and the Contingent B Shares may negatively impact the RBS Group's capital position

One of the key objectives of the APS and the issuance of £25.5 billion of B Shares 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 RBS Group members. The RBS Group has entered 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. 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, the regulatory capital treatment may differ 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. 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 ratings 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 the 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 APS may be greater than the benefits received

The costs of participating in the APS incurred by the RBS Group to HM Treasury include, among others, a fee of £700 million per annum, payable in advance for each of 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 amounts that may be received under the APS (which amounts are difficult to quantify precisely) may be less than the costs of participation which are themselves also difficult to quantify. The aggregate effect of the joining, establishment, operational and exit costs and fees and expenses of, and associated with, the APS may significantly reduce or even eliminate the benefit to the RBS Group of the APS.

Participation in the APS may result in greater tax liabilities for the RBS Group and the loss of potential tax benefits

The RBS Group can opt (with the consent of HM Treasury) to satisfy the annual fee in respect of both the APS and the Contingent Subscription and any APS exit fee by waiving certain United Kingdom tax reliefs that are treated as deferred tax assets. The RBS Group has not opted to do

so to date, but if the RBS Group so opts in the future, it is difficult to value accurately the cost to the RBS Group, which depends 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 waiver of the right to certain United Kingdom tax reliefs that are treated as deferred tax assets (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.

There are significant costs associated with termination of the RBS Group's participation in the APS

In order to terminate the RBS Group's participation in the APS, the RBS Group must have FSA approval and must pay an exit fee. 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 and could have an adverse impact on the RBS Group's 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, is 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 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 RBS Holdings N.V. (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 RBS Holdings N.V. or its wholly-owned subsidiaries, RBS Holdings N.V. 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 be 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.

Risk factors *continued*

If the RBS Group loses cover under the APS in respect of any Covered Asset held by RBS Holdings N.V. 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.

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 RBSG, and could result in the delisting of RBSG from the Official List

On 22 December 2009, RBSG 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 RBSG to above 75 per cent of RBSG's ordinary issued share capital, which would put RBSG 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 RBSG may apply to the FSA in its capacity as the competent authority under the

FSMA 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 RBSG from the Official List and potentially other exchanges where its Securities are currently listed and traded.

Participation in the APS may give rise to litigation and regulatory risk
In order to fulfil (or as a consequence of fulfilling) its disclosure obligations under the APS by disclosing certain information to HM Treasury (and, as a result of notices issued by it, the FSA), the RBS Group may incur the risk of civil suits, criminal liability or regulatory actions.

Adverse regulatory action or adverse judgments in litigation could have a significant 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 be required to remove Covered Assets from the APS so as not to be required to disclose such information to HM Treasury, 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.

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 of 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 2 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.

Additional information *continued*

Glossary of terms *continued*

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.

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.

Forbearance is the term generally applied to an agreement, principally in relation to secured loans with retail customers experiencing temporary financial difficulty, to a payment moratorium, to reduced repayments or to roll up arrears. Forbearance loans are a subset of Renegotiated loans.

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 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 impaired loans.

Impairment allowance - see Loan impairment provisions.

Additional information *continued*

Glossary of terms *continued*

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 date. 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.

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-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 impaired 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 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 encompasses not only revisions to the terms of a loan such as a maturity extension, a payment moratorium, a concessionary rate of interest but also the restructuring of all or part of the exposure including debt forgiveness or a debt for equity swap. Loans renegotiated as part of the ongoing banking relationship with a creditworthy customer, are treated as new loans.

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.

Restructured loans - see Renegotiated loans.

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 impaired 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).

Additional information *continued*

Glossary of terms *continued*

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.

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.

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