RBS
The Royal Bank of Scotland Group

Annual Results 2008

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Forward-looking statements

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

In particular, this document includes forward-looking statements relating, but not limited, to the Group’s potential exposures to various types of market risks, such as interest rate risk, foreign exchange rate risk and commodity and equity price risk. Such statements are subject to risks and uncertainties. For example, certain of the market risk disclosures are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market risk disclosures are only estimates and, as a result, actual future gains and losses could differ materially from those that have been estimated.

Other factors that could cause actual results to differ materially from those estimated by the forward-looking statements contained in this document include, but are not limited to: the extent and nature of future developments in the credit markets, including the sub-prime market, and their impact on the financial industry in general and the Group in particular; the effect on the Group’s capital of write downs in respect of credit market exposures; the Group’s ability to achieve revenue benefits and cost savings from the integration of certain of ABN AMRO’s businesses and assets; general economic conditions in the UK and in other countries in which the Group has significant business activities or investments, including the United States; the monetary and interest rate policies of the Bank of England, the Board of Governors of the Federal Reserve System and other G-7 central banks; inflation; deflation; unanticipated turbulence in interest rates, foreign currency exchange rates, commodity prices and equity prices; changes in UK and foreign laws, regulations and taxes; changes in competition and pricing environments; natural and other disasters; the inability to hedge certain risks economically; the adequacy of loss reserves; acquisitions or restructurings; technological changes; changes in consumer spending and saving habits; and the success of the Group in managing the risks involved in the foregoing.

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

Presentation of information

Acquisition of ABN AMRO

On 17 October 2007, RFS Holdings B.V. ('RFS Holdings''), a company jointly owned by RBS, Fortis Bank Nederland (Holding) N.V. ('Fortis') and Banco Santander S.A. ('Santander') (together, the 'Consortium Members') and controlled by RBS, completed the acquisition of ABN AMRO Holding N.V. ('ABN AMRO').

RFS Holdings is implementing an orderly separation of the business units of ABN AMRO with RBS retaining the following ABN AMRO business units:

- Continuing businesses of Business Unit North America;
- Business Unit Global Clients and wholesale clients in the Netherlands (including former Dutch wholesale clients) and Latin America (excluding Brazil);
- Business Unit Asia (excluding Saudi Hollandi); and
- Business Unit Europe (excluding Antonveneta).

Certain other assets will continue to be shared by the Consortium Members.

On 3 October 2008, the State of the Netherlands acquired Fortis Bank Nederland (Holding) N.V. including Fortis' participation in RFS Holdings that represents the acquired activities of ABN AMRO.

Pro forma results

Pro forma results have been prepared that include only those business units of ABN AMRO that will be retained by RBS and assuming that the acquisition of ABN AMRO was completed on 1 January 2007. The per share data have been calculated on the assumption that the rights issue of 11 shares for 18 shares held for 200 pence per share and the capitalisation of 1 share for every 40 shares held occurred on 1 January 2007. No adjustments have been made in respect of the placing and open offer. The financial review and divisional performance in this Company Announcement focus on the pro forma results. The basis of preparation of the pro forma results is detailed on page 53.

Given the significant write-downs on the Group's credit market exposures, and in order to provide a basis for comparison of underlying performance, these write-downs and other one-off items are shown separately in the pro forma income statement.

Statutory results

RFS Holdings is jointly owned by the Consortium Members. It is controlled by RBS and is therefore fully consolidated in its financial statements. Consequently, the statutory results of the RBS Group for the years ended 31 December 2007 and 2008 include the results of ABN AMRO for 76 days and the full year respectively. The interests of the State of the Netherlands and Santander in RFS Holdings are included in minority interests.

Restatements

Divisional results for 2007 have been restated to reflect the new organisational structure announced in February 2008. These changes do not affect the Group’s results.

The statutory income statement and cash flow statement for the year ended 31 December 2007 have been restated to reflect the reclassification of Banco Real as a discontinued operation.

The pro forma and statutory balance sheets as at 31 December 2007 have been restated to reflect the finalisation of the purchase accounting adjustments in respect of ABN AMRO and the netting of certain derivative contracts.

2008 Key points

Strategic Review

The Group is announcing a sweeping restructuring plan aimed at restoring standalone strength. We expect to:

- Shift ~20% (£240 billion) of funded assets to Non-core Division for disposal/run down over 3-5 years
- Deliver substantive change in all Core Division businesses each of which must meet 5 key tests[1]
- Centre on UK with smaller, more focused global operations
- Radically restructure GBM, taking out 45% of capital employed
- Cut more than £2.5 billion out of the Group's cost base
- Have access to the Government Asset Protection Scheme
- Drive major changes to management, processes and culture

Key Financials – pro forma

Our financial results verify the guidance we provided in our trading statement of 19 January 2009:

Operating profit[2]	**£80 million**
Loss attributable to ordinary shareholders[3]	**£7.9 billion**
Total income[4]	**£26.9 billion**
Impairment losses[5]	**£7.0 billion**
Credit market losses[6]	**£7.8 billion**
Write down of goodwill and other intangible assets[7]	**£16.2 billion**
Total capital ratio	**14.2%**
Core Tier 1 capital ratio[8]	**7.0%**
Tier 1 capital ratio	**9.9%**
Loss per ordinary share	**(61.0p)**

Commenting Stephen Hester, RBS Group Chief Executive, said:

"We have moved purposefully to take major decisions that are necessary to restructure the Group. We are charting a path to standalone strength and with it the goal of justifying the support of the UK Government and all our shareholders.

It is our job now to ensure that RBS moves forward. There are real and enduring strengths in the Group illustrated by good performances across a range of businesses in a very difficult year. The restoration of the company's health will be based around these powerful customer franchises.

We are, of course, in a privileged position to be able to restructure the Group with support from the UK Government. With that privilege come responsibilities that we mean to fulfil. We have many difficult decisions ahead of us and continued and major uncertainties in our markets. How we do business will be as important as the business we do as we navigate our way through these challenges. Everyone at RBS is now focused on the drive toward recovery".

(1) Strategic tests: Top tier competitive position in enduring customer franchise; 15%+ ROE in normal markets; Proportionate use of balance sheet, risk & funding; Capable of organic growth – but "market limited"; Connected to the Group – customers, products, people (2) Profit before tax, credit market write-downs and one-off items, purchased intangibles amortisation, write-down of goodwill and other intangible assets, integration costs, restructuring costs and share of shared assets (3) Before write-down of goodwill and other intangible assets (4) Excluding credit market write-downs and one-off items and share of shared assets. (5) Excluding impairment losses on reclassified assets. (6) Net of CDS hedging (7) net of tax (8) Pro forma for conversion of Preference Shares

2008 Key points

Key Financials – statutory

Attributable loss	**£24.1 billion**
Loss before tax	**£40.7 billion**
Impairment losses	**£8.1 billion**
Total capital ratio	**14.1%**
Core Tier 1 capital ratio	**6.8%**
Tier 1 capital ratio	**10.0%**

Results summary – pro forma

	2008 £m	2007 £m	Movement £m
Total income (1)	**26,875**	33,564	**(6,689)**
Operating expenses (2)	**15,916**	16,618	**(702)**
Impairment (3)	**6,962**	2,104	**4,858**
Underlying profit (4)	**80**	10,314	**(10,234)**
Credit market write-downs and one-off items (see Note 2)	**6,107**	1,026	**5,081**
Purchased intangibles amortisation	**443**	124	**319**
Integration costs	**1,050**	108	**942**
Restructuring costs	**307**	-	**307**
Share of shared assets	**300**	94	**206**
(Loss)/profit before tax (5)	**(8,127)**	8,962	**(17,089)**
(Loss)/profit attributable to ordinary shareholders	**(7,855)**	6,823	**(14,678)**
Write-down of goodwill and other intangible assets (less tax credit of £715 million)	**16,196**	-	**16,196**
(Loss)/profit attributable to ordinary shareholders	**(24,051)**	6,823	**(30,874)**
Cost:income ratio (6)	**59.2%**	49.5%	
Basic (loss)/earnings per ordinary share (7)	**(61.0p)**	40.8p	**(101.8p)**
Adjusted (loss)/earnings per ordinary share (7,8)	**(5.2p)**	44.5p	**(49.7p)**

For basis of preparation of pro forma results see page 53. Reconciliations from statutory to pro forma data are provided in Appendix 1.

Notes:

(1) *excluding credit market write-downs and one-off items and share of shared assets.*

(2) *excluding one-off items, purchased intangibles amortisation, write-down of goodwill and other intangible assets, integration costs, restructuring costs and share of shared assets.*

(3) *excluding impairment losses on reclassified assets.*

(4) *profit before tax, credit market write-downs and one-off items, impairment losses on reclassified assets, purchased intangibles amortisation, write-down of goodwill and other intangible assets, integration costs, restructuring costs and share of shared assets.*

(5) *excluding write-down of goodwill and other intangible assets.*

(6) *the cost:income ratio is based on total income and operating expenses as defined in (1) and (2) above.*

(7) *earnings per ordinary share are based on the assumption that the rights issue and capitalisation issue were completed on 1 January 2007.*

(8) *adjusted earnings per ordinary share is based on earnings adjusted for credit market write-downs and one-off items, purchased intangibles amortisation, write-down of goodwill and other intangible assets, integration costs and share of shared assets.*

Results summary – statutory

	2008 **£m**	2007 £m	**Movement** **£m**
Total income	**25,868**	30,366	**(4,498)**
Operating expenses (1)	**54,033**	13,942	**40,091**
Impairment	**8,072**	1,968	**6,104**
(Loss)/profit before tax	**(40,667)**	9,832	**(50,499)**
(Loss)/profit attributable to ordinary shareholders	**(24,137)**	7,303	**(31,440)**
Basic earnings per ordinary share	**(145.7p)**	64.0p	**(209.7p)**

Note:
(1) *including purchased intangibles amortisation of £443 million (2007: £262 million), write-down of goodwill and other intangible assets of £32,581 million and integration and restructuring costs of £1,357 million (2007: £108 million).*

Chairman's review

My first statement to you as Chairman follows an exceptionally difficult period in the Royal Bank of Scotland's history. The last 12 months or so have been painful for our shareholders and employees and sometimes testing for our customers. We owe our continued independence to the UK government and taxpayers and are very thankful for their support. The external environment has seen unprecedented turbulence in bank and other financial markets and deteriorating economic conditions around the world. Our disappointing financial results reflect these circumstances and our exposure to them.

Despite this, I believe strongly that RBS can be successful once again. I am privileged to have been given the opportunity to chair the Group. This remains a truly international company with many excellent businesses. Our roots may be in Scotland and our largest market in the UK, but we also employ 10,000 people in India, enjoy strong positions on the island of Ireland through Ulster Bank and in our United States markets through Citizens. The Global Markets businesses are precisely that: global. They will continue to operate in the leading financial centres, supporting our corporate, institutional and financial sector clients around the world. The international nature of the Group is reflected by the fact that during 2008 we were able to benefit from liquidity support provided by central banks in a number of jurisdictions.

With hard work, determination and a willingness to take tough decisions we have the people and capabilities to enable the Group to recover. We can make it a profitable investment, a model corporate citizen in all of the countries in which it operates and an excellent place to work.

Justifying the support of our shareholders

Twice during 2008 the Group sought additional capital from shareholders to enable it to weather the very testing environment and to achieve the higher capital ratios that markets now demand. On the second occasion, the capital raising was underwritten by the UK government and in November it became the Group's majority shareholder.

The UK Government wants RBS to operate on a commercial basis and intends to act as an arms length commercial shareholder, which will sell its interests in RBS and other banks at the earliest attractive time. Our interests coincide. We are working to restore the Group's financial performance in order to allow us to repay the UK taxpayer as soon as is practicable.

An inevitable but regrettable consequence of the successive capital raising exercises has been the dilution of the interests of existing shareholders. My predecessor Sir Tom McKillop apologised to shareholders for the impact on them of the erosion of their investments, a sentiment I echo. Those of us now charged with leading the Group are committed to implementing measures which will allow us to restore the Group to standalone financial health in the interests of all shareholders.

It is not appropriate to pay any dividend on the Ordinary Shares in 2009. However, the Board is very mindful that dividends are an extremely important part of shareholder return and income. It is the Board's intention over time to return to paying dividends, taking account of the Group's capital position, retained earnings and prospects. To that end, we welcome the fact that the existing prohibition on the payment of dividends on the Ordinary shares will be removed when the Preference Shares held by UKFI are redeemed.

Changing the way we work

To achieve its objectives, the company needs to change not just the business we do but how we do business. That includes our governance arrangements. The directors decided that a restructured Board with fewer members would be better able to engage in the restructuring process which the company will undertake. As a result, a number of Non-Executive Directors resigned from the Board in February 2009. I would like to thank each of them for their service to the company. In particular, I wish to acknowledge the contribution of Sir Tom McKillop who chaired RBS through testing times with great dedication and integrity.

We will appoint a further three Non-Executive Directors in due course.

Our People

Last year was also a period of great anxiety and uncertainty for our employees. Despite this, the vast majority of them contributed to a profitable year for their own businesses and they demonstrated the commitment that will be needed to return the Group to good health. Unfortunately, however, the uncertainty is not over and many of our people will be affected by the steps we must take to restore RBS to strength. My experience of leading businesses through periods of significant change has taught me that people are resilient and work best when they have certainty over strategic direction, clarity about the role they are being asked to play and feel engaged in pursuing shared objectives. We have already begun to provide certainty and clarity over strategy and management structures. My further commitment to our people is that we will move as swiftly as possible where change is required and that we will work to ensure that those affected by change are the first to know about it.

We must also engage our people with a new employment proposition which sets incentives that reward them for delivering sustained and sustainable success.

Aligning remuneration with long-term shareholder value

In recognition of the crisis in global financial services and the unprecedented losses incurred by the RBS Group in 2008, the Remuneration Committee of the Board has been working to bring about fundamental change to the way remuneration works throughout the Group. There is an obvious need for very significant change to compensation policies and practice across the industry and we intend that RBS will be fully engaged in the necessary process of change.

Our approach has sought to balance the reality of our current losses at Group level with a need to offer a competitive remuneration package for teams and individuals that are performing well and in a manner that is sustainable in the long-term.

Our customers and communities

Most of our businesses were profitable in 2008. That was because they met their customers' needs. A consistent hallmark of RBS has been the ability to work with our customers and to provide them with a high quality of service, whether they are personal or corporate customers, be they in the UK, Ireland, the USA or across continental Europe and Asia. RBS has frequently led our peers in service quality league tables.

We are grateful for the support our customers gave us during 2008, when their faith in us might understandably have been dented, and recognise that our plans will succeed only if we continue to serve them well.

In every country where RBS operates, we do so within a wider community. Our activities affect, and are affected by the customers, governments, suppliers and other stakeholders with whom we interact. On joining the company, it was encouraging to learn that we provide banking services to more small firms than any other UK bank and that our flagship money advice and financial education programme, MoneySense, has been in place for many years. As an international company, we have extended MoneySense to Ireland and the United States of America. We support the causes our staff care about and invest to improve the capacity of community to generate wealth. These programmes are more relevant than ever to the challenges that lie ahead.

We recognise that our reputation has been damaged by the events of the last year. So, too, has the reputation of the banking industry in countries across the globe. We are determined to rebuild our reputation, and to demonstrate leadership in the industry in this respect, partly through our core purpose of business success, but also by playing a constructive and responsible role in the communities in which we operate.

The Way Forward

I am confident that we can, must and will restore RBS Group to standalone financial strength. Last year was undeniably tough and a worsening economic environment means that 2009 will present significant challenges in all of our markets. The path to recovery will be neither smooth nor straight. But we build on a number of strengths: excellent businesses, talented people and, above all, millions of loyal customers around the world who recognise the quality of service that we provide. By doing our best by them, in all of our enduring franchises around the world, we will take the actions that will deliver once again sustainable returns for our shareholders.

Philip Hampton
Chairman

As this is my first letter to RBS shareholders, I should open by saying how aware we all are of the responsibility for leading this institution into better times. We have a great importance to 40 million customers, to many corporations and governments worldwide, to our shareholders and to all those in the communities we serve. In common with many, we are facing tough times. We will do our best to work through these, to support our customers and to restore RBS to standalone financial health and success.

2008 Results

While a downturn was anticipated, no one could have foretold the unprecedented market disruption and global economic downturn that we now experience. With roots in economic imbalances across the world, the downturn has weakened many. However, that is little consolation for the particular vulnerability that RBS has exhibited.

In 2008 RBS's overall results were bad, with net attributable losses, before goodwill impairments, of £7.9 billion. This is particularly disappointing since many parts of our business did well, serving customers and generating high quality profitability. All our divisions were profitable except Global Banking and Markets (GBM) and Asia Retail & Commercial Banking. Even in GBM, underlying income reached £10.2 billion on the back of many strong business performances. Unfortunately these profits were more than wiped out by credit and market losses in concentrated areas around proprietary trading, structured credit and counterparty exposures. Over 50% of these losses pertained to ABN AMRO-originated portfolios.

In addition, the change in market outlook and our vulnerability thereto has required a £16.2 billion accounting write-down of goodwill and other intangibles relating to prior year acquisitions, most notably of ABN AMRO in 2007 and Charter One in the US in 2004. This non-cash item has minimal impact on capital but does highlight the risk of acquisitions if economic conditions adversely change.

From a capital perspective, successive capital raisings have substantially strengthened RBS's capital ratios. Reported losses have only partially eroded these, and our core Tier 1 ratio stood at 7.0% at the end of 2008, pro forma for the conversion of our preference shares, compared with 4.0% a year earlier. Additionally, the funded balance sheet was reduced by £93 billion, or 17% in constant currency terms. Unfortunately, the extreme dislocation of markets has impeded the risk reduction we target, leaving much still to do. Moreover, the fall in sterling exchange rates inflates the optics of our international balance sheet and this, plus extreme market movements, also increases the accounting value of our derivatives balances, albeit recording amounts that would be largely netted off under US GAAP.

RBS has strong businesses, has taken steps to restore its capital base and benefits from clear Government support. It is our primary task to rebuild standalone strength in the coming years.

The Task We Face

We are intensely engaged in finalising a strategic restructuring plan for RBS. The goal is to correct those factors that made us particularly vulnerable to the downturn and to further adjust our business to reflect changes in the environment facing our industry. While the plan will not be complete until Q2, we have decided a lot already.

Our strategic plans will take 3-5 years to execute, given the headwinds of economic downturn. Nevertheless, we expect to make progress each and every year.

Our aspiration is that RBS should again become one of the world's premier financial institutions, anchored in the UK but serving individual and institutional customers here and globally, and doing it well. We aim for AA category standalone credit status and to rebuild shareholder value, along the way enabling the UK Government to sell down its shareholding.

We should be known both for our businesses and for how we manage them. We want to restrict our activities to serving enduring customer franchises, with top tier competitive positions where we choose to compete. Our businesses will target 15%+ return on equity and primarily organic growth at rates consistent with the markets in which they operate. Our businesses should reinforce each other with shared products, customers and expertise. Our risks should be diversified, well controlled and proportionate to the business and customer opportunity.

In management style we want to be purposeful, to "make it happen" for our customers and then for our shareholders. But our efforts will be anchored in strategic understanding of our businesses and focus on long term, quality profitability. Our business mix should be more biased to stable customer businesses than before in retail, commercial and wholesale. We aim to rely less on volatile unsecured wholesale funding.

Strategic Restructuring Plan

We have embarked on a sweeping restructuring of the Group that will fit our activities to the goals outlined above. While the details of the Strategic Plan will be refined over the coming weeks, we are now able to announce the following:

- We will create a "Non-Core" Division of RBS during Q2, separately managed, but within the existing legal structures of the Group and matrix-managed to donating Divisions where necessary. This Division will have approximately £240 billion of third party assets, £145 billion of derivative balances and £155 billion of risk-weighted assets, comprising individual assets, portfolios and businesses of the Group that we intend to run off or dispose of during the next 3-5 years. The specific timetable will vary in each case but will be as fast as we judge consistent with optimising shareholder value and risk. Approximately 90% of the Non-Core Division will consist of GBM assets, primarily linked to proprietary portfolios, excess risk concentrations and illiquid 'originate and hold' asset portfolios. The rest of the Non-Core Division will be risk concentrations, 'out of footprint' assets and smaller, less advantaged businesses within our Regional Markets activities across the world.

  As part of this effort it is intended that our representation in approximately 36 of the 54 countries we operate in around the world will be significantly reduced or sold. We will remain strong in all our major existing global hubs, however.

  Given the commercial and human sensitivity of these issues, detail on this will not be given until the interim results.

  The income, expenses, impairments and credit market and other trading asset write-downs associated with the Non-Core Division in 2008 were approximately £3.9 billion, £1.1 billion, £3.2 billion and £9.2 billion respectively.

- In addition to eliminating expenses associated with the Non-Core Division, we have launched a restructuring plan to make efficiency savings across the Group, aimed at achieving run-rate reductions by 2011 of greater than £2.5 billion (16% of 2008 cost base) at constant exchange rates. This will involve a wide range of re-engineering and other measures and, regrettably, reductions in employment. This target excludes any impact of inflation, incentive pay movements or cost reductions arising from business exits or the impact of new projects (if any). It includes the £0.5 billion of ABN AMRO integration benefits previously announced but not reflected in 2008 expenses. We will book one-off charges against these actions over the next three years, with run-rate cost savings expected to provide 'payback' in 1.5 to 1.75 years.

- We plan to retain each of our major business Divisions since we believe, with intensive restructuring, they can meet the attractive business characteristics outlined as targets above. In many cases the restructuring of these businesses to achieve our goals will be far-reaching, nevertheless. The greatest element of restructuring will be in GBM as signalled above. A substantial shrinkage of size, product and geographic scope will take place. This should leave GBM positioned profitably around those of its existing core strengths that rest on profitable customer franchise business with significantly less illiquid risk overall.

- At all times we will responsibly compare the value to RBS of each of our businesses with realistic alternatives and take different action if they prove compelling. However, the distressed and pessimistic state of markets for financial assets and businesses offers little immediate encouragement in that regard.

- Alongside our business restructuring activities will be substantive changes to management and internal processes. There will continue to be changes of personnel as we promote and reassign internal talent and add to our ranks externally. Our Manufacturing division will re-align with our customer-facing businesses. Businesses will have clear bottom-line returns, allocated equity and balance sheet and funding goals. While we drive for profit, there will be a concentration on earnings quality and sustainability, driven by strategic plans, to ensure alignment of our businesses to their markets and their risk targets. People evaluation and incentivisation will meet best practice levels to support the revised mission of the Company. This will be underpinned by a full suite of risk and funding constraints, including concentration limits.

We have already begun this major change programme. To carry it through in parallel with running our continuing business in difficult markets will test our management capacity. We expect to be successful overall, though we will inevitably have setbacks and make mistakes along the way. But there is no alternative. RBS must change in a far-reaching way. If we do that, the strength, quality and power that are already present in our business across the world will have the chance to shine through once again.

Outlook

To make any forecast is hazardous, beyond the expectation that 2009 will be a very tough year for the world economy. RBS, in common with all banks, will see some erosion of underlying income levels as a result of weaker business activity and low interest rates squeezing savings margins whilst credit costs rise, probably sharply. We hope that markets will be less disrupted than in 2008, with lower associated write-downs, but time will tell. 2009 has, in fact, started positively for our businesses.

At the time of writing, RBS is in discussions with the UK Government concerning participation in the proposed Asset Protection Scheme (APS). This would be subject to shareholder vote in due course. The result of the APS discussions will have a material impact on RBS's outlook, positive or negative depending on outcome. More information will be made available as soon as practicable.

Notwithstanding the challenging outlook, our businesses all around the world are inherently good and fully engaged in sustaining as robust a performance as the environment permits. And the strategic restructuring we have embarked on will see high levels of activity designed to reposition RBS successfully.

I believe RBS can come to be regarded again as one of the world's premier financial institutions. My special thanks go to all my colleagues around the world serving our customers every day, and redoubling their efforts to move RBS forward once more.

Stephen Hester
Group Chief Executive

Summary consolidated income statement
for the year ended 31 December 2008 – pro forma

In the income statement set out below, credit market write-downs and one-off items, amortisation of purchased intangible assets, write-down of goodwill and other intangible assets, integration costs, restructuring costs and share of shared assets are shown separately. In the statutory condensed consolidated income statement on page 66, these items are included in non-interest income, operating expenses and impairment, as appropriate.

	2008	2007
	£m	£m
Net interest income	**15,939**	12,382
Non-interest income (excluding insurance net premium income)	**5,227**	15,200
Insurance net premium income	**5,709**	5,982
Non-interest income excluding credit market write-downs and one-off items	**10,936**	21,182
Credit market write-downs and one-off items (Note 2)	**(5,641)**	(1,268)
Non-interest income	**5,295**	19,914
Total income	**21,234**	32,296
Operating expenses excluding one-off items	**15,916**	16,618
One-off items (Note 2)	**-**	(242)
Profit before other operating charges	**5,318**	15,920
Insurance net claims	**3,917**	4,528
Operating profit before impairment losses	**1,401**	11,392
Impairment losses before reclassified asset impairment	**6,962**	2,104
Impairment losses on reclassified assets (Note 2)	**466**	-
Group operating (loss)/profit*	**(6,027)**	9,288
Amortisation of purchased intangible assets	**443**	124
Integration costs	**1,050**	108
Restructuring costs	**307**	-
Share of shared assets	**300**	94
(Loss)/profit before tax	**(8,127)**	8,962
Tax	**1,280**	(1,709)
(Loss)/profit for the period	**(6,847)**	7,253
Minority interests	**412**	184
Other owners' dividends	**596**	246
(Loss)/profit attributable to ordinary shareholders before write-down of goodwill and other intangible assets	**(7,855)**	6,823
Write-down of goodwill and other intangible assets (less tax credit of £715 million)	**(16,196)**	-
(Loss)/profit attributable to ordinary shareholders	**(24,051)**	6,823
Basic (loss)/earnings per ordinary share (Note 8)	**(61.0p)**	40.8p
Adjusted (loss)/earnings per ordinary share (Note 8)	**(5.2p)**	44.5p

* Before purchased intangibles amortisation, write-down of goodwill and other intangible assets, integration costs, restructuring costs and RBS share of Consortium shared assets.

Pro forma results

Profit
Group operating profit, excluding credit market write-downs and one-off items, impairment losses on reclassified assets, amortisation of purchased intangible assets, write-down of goodwill and other intangible assets, integration costs, restructuring costs and share of shared assets, was £80 million, compared with a profit of £10,314 million in 2007. The reduction is primarily a result of a substantial decline in non-interest income, a number of specific losses such as counterparty failures, and a marked increase in the credit impairment charge, reflecting weakness in financial markets and a deteriorating global economy.

Losses from previously disclosed credit market exposures increased to £7,781 million, compared with £2,387 million in 2007, with the great majority incurred in the first half of the year. Other one-off items amounted to a credit of £1,674 million, 23% higher than in 2007, principally as a result of a £1,232 million increase in the carrying value of own debt carried at fair value. After integration costs, restructuring costs, amortisation of purchased intangibles, write-down of goodwill and other intangible assets and share of shared assets, the Group recorded a loss before tax of £25,038 million, compared with a profit before tax of £8,962 million in 2007.

After tax, minority interests and preference share dividends, the loss attributable to ordinary shareholders was £24,051 million, compared with an attributable profit of £6,823 million in 2007.

Total income
Total income, excluding credit market write-downs and one-off items, declined by 20% to £26,875 million, with a significant deterioration experienced during the second half of the year principally as a result of £5.8 billion of trading asset write-downs, counterparty failure and incremental reserving within GBM. While income increased in 2008 in Global Transaction Services, and held steady in Regional Markets and Insurance, a significant reduction occurred in Global Banking & Markets, where a strong performance in rates, currencies and commodities was offset by marked deterioration in credit markets and equities.

Net interest income
Net interest income increased by 29% to £15,939 million, with average loans and advances to customers up 17% and average customer deposits up 6%. Group net interest margin rose from 2.00% to 2.10% largely reflecting the success of the rates business in a declining interest rate environment. However, margins tightened within Regional Markets as market interest rates fell, with deposit markets remaining competitive and price adjustments on lending taking some time to feed through to the back book.

Non-interest income
Non-interest income was severely affected by the weakness in financial markets experienced over the course of the year, particularly in the fourth quarter. Excluding credit market write-downs and one-off items, non-interest income totalled £10,936 million, 48% lower than in 2007. While the decline was particularly marked in GBM's credit markets and equities businesses, with reduced business volumes and mounting mark-to-market trading losses, Regional Markets also saw non-interest income fall in the latter part of the year as declining consumer confidence led to lower demand for credit and other financial products.

Operating expenses
Total operating expenses were reduced by 4% to £15,916 million, with cost growth in the Group's core retail and commercial banking franchises offset by efficiency programmes and a significant reduction in Global Banking & Markets staff costs. The Group cost:income ratio deteriorated to 59.2%, compared with 49.5% in 2007, largely reflecting the impact on income of the year's difficult market conditions.

Net insurance claims

Net insurance claims fell by 13% to £3,917 million. General insurance claims fell by 7%, reflecting improved risk selection, better claims management and the non-recurrence of the severe floods experienced in 2007. Bancassurance claims declined by 64% as a result of movements in financial market values.

Impairment losses

Credit impairment losses (excluding reclassified assets) increased to £6,962 million in 2008, compared with £2,104 million in 2007. The Group experienced a pronounced deterioration in impairments in the second half of the year, as financial stress spread to a broad range of customers. The greatest increase in impairments occurred in GBM, where fourth quarter impairments totalled £2,938 million, including a loss of approximately £900 million on the Group's exposure to LyondellBasell. However, the Regional Markets businesses in all geographies also experienced a noticeable increase in impairments in the second half, particularly in the UK and Irish corporate and US personal segments.

Impairments represented 0.46% of gross loans and advances, excluding reverse repos, in the first half but reached 1.41% in the second half. For 2008 as a whole, impairments amounted to 0.91% of loans and advances, excluding reverse repos, compared with 0.37% in 2007.

Risk elements in lending and potential problem loans at 31 December 2008 represented 2.69% of loans and advances, excluding reverse repos, compared with 1.49% a year earlier. Provision coverage was 50%, compared with 59% at 31 December 2007 reflecting the higher proportion of secured loans included in risk elements in lending and potential problem loans.

Credit market losses

Losses for 2008 relating to the Group's previously identified credit market exposures totalled £7,781 million, net of hedging gains of £1,642 million. This includes impairment losses of £466 million incurred on credit market assets reclassified out of the 'held-for-trading' category in line with the amendments to IAS 39 'Financial Instruments: Recognition and Measurement' issued in October. While the majority of these write-downs were incurred in the first half of 2008, the severity of the financial market dislocation intensified in the fourth quarter, resulting in further losses in particular on the Group's structured credit portfolios. Further details on credit market exposures are set out in Appendix 2.

Write-down of goodwill and other intangible assets

After reviewing the carrying value of goodwill and other purchased intangible assets, the Group has recorded an impairment charge of £16,196 million, net of a tax credit of £715 million. Of this charge, £7,678 million relates to part of the goodwill in respect of the acquisition of ABN AMRO, while other significant impairments have been recorded on part of the Citizens/Charter One goodwill of £4,382 million, part of the NatWest goodwill (principally allocated to Global Banking & Markets) of £2,742 million and other goodwill of £720 million. Other intangible asset impairments of £1,389 million principally relate to the write-down in the value of customer relationships recognised on the acquisition of ABN AMRO (see note 4 on page 54).

These impairments have no cash impact, and minimal impact on the Group's capital ratios.

Other non-operating items

Integration and restructuring costs totalled £1,357 million, primarily reflecting the integration of ABN AMRO into the Group, while the amortisation of purchased intangibles increased to £443 million from £124 million.

Taxation

The Group recorded a tax credit of £1,280 million in 2008, compared with a tax charge of £1,709 million in 2007.

Earnings

Basic earnings per ordinary share decreased from 40.8p to (61.0p). Adjusted earnings per ordinary share fell from 44.5p to a loss of 5.2p per share (see note 8 on page 56). The number of shares in issue increased to 39,456 million at 31 December 2008, compared with 10,006 million in issue at 31 December 2007, reflecting the Group's capital raisings in June and December and the capitalisation issue in lieu of the interim dividend for 2008.

Capital ratios

Risk-weighted assets totalled £577.8 billion at 31 December 2008, an increase of 19% compared with end-2007 RWAs restated on a Basel II basis, or 18% from the Basel I RWA figure reported for 2007. The growth in RWAs was largely related to movements in exchange rates and the procyclical nature of the Basel II regulatory regime.

On a proportionally consolidated basis, the Group's Core Tier 1 ratio at 31 December 2008 was 6.1%, compared with 4.0% at 1 January 2008, on a Basel II basis. The Tier 1 ratio was 9.9% at 31 December 2008 (6.8% at 1 January 2008) and the total capital ratio was 14.2% (10.9% at 1 January 2008).

On 19 January 2009 the Group announced a capital restructuring whereby HM Treasury will fully underwrite an open offer to raise £5 billion through an issue of new ordinary shares, the proceeds from which will be used to redeem the £5 billion of preference shares it holds. The restructuring will not affect the Group's Tier 1 or total capital ratios. However, had the capital restructuring completed at 31 December 2008, the Group's Core Tier 1 ratio would have been 7.0%.

Global Banking & Markets 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. In 2008 the division was organised along four principal business lines: rates, currencies, and commodities, including RBS Sempra Commodities LLP (the commodities-marketing joint venture between RBS and Sempra Energy which was formed on 1 April 2008); equities; credit markets; and asset and portfolio management.

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

UK Retail & Commercial Banking (RBS UK) comprises retail, corporate and commercial banking and wealth management services. It operates through a range of channels including on-line and fixed and mobile telephony, and through two of the largest networks of branches and ATMs in the UK.

In the Retail market, RBS UK serves over 15 million personal customers through the RBS and NatWest brands. It offers a full range of banking products and related financial services including mortgages, bancassurance products, deposit accounts, and credit and charge cards.

RBS UK holds a leading market share across all of the Business & Commercial and Corporate sectors. Through its network of relationship managers it distributes a full range of banking, finance and risk management services, including market-leading Invoice Finance and Asset Finance offerings.

The UK wealth management arm offers high quality private banking and investment services through the Coutts, Adam & Company, RBS International and NatWest Offshore brands.

US Retail & Commercial Banking provides financial services primarily through the Citizens and Charter One brands.

Citizens is engaged in retail and corporate banking activities through its branch network in 13 states in the United States and through non-branch offices in other states. Citizens was ranked the tenth-largest commercial banking organisation in the United States based on deposits as at 30 September 2008.

Europe & Middle East Retail & Commercial Banking comprises Ulster Bank and the Group's combined retail and commercial businesses in Europe and the Middle East.

Ulster Bank provides a comprehensive range of financial services across the island of Ireland. Its retail banking arm has a network of branches and operates in the personal, commercial and wealth management sectors, while its corporate markets operations provide services in the corporate and institutional markets.

Asia Retail & Commercial Banking is present in markets including India, Pakistan, China, Taiwan, Hong Kong, Indonesia, Malaysia and Singapore. It provides financial services across four segments: affluent banking, cards and consumer finance, business banking and international wealth management, which offers private banking and investment services to clients in selected markets through the RBS Coutts brand.

RBS Insurance sells and underwrites retail and SME insurance over the telephone and internet, as well as through brokers and partnerships. Its brands include Direct Line, Churchill and Privilege, which sell general insurance products direct to the customer, as well as Green Flag and NIG. Through its international division, RBS Insurance sells general insurance, mainly motor, in Spain, Germany and Italy. The Intermediary and Broker division sells general insurance products through independent brokers.

Group Manufacturing comprises the Group's worldwide manufacturing operations. It 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. Manufacturing 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 has become the centre of excellence for managing large-scale and complex change.

The Centre comprises group and corporate functions, such as capital raising, 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.

Divisional performance

The profit/(loss) of each division before credit market write-downs and one-off items, amortisation of purchased intangible assets, write-down of goodwill and intangibles, integration costs, restructuring costs, share of shared assets and after allocation of manufacturing costs where appropriate (“Group operating profit”) are shown below. The Group manages costs where they arise. Customer-facing divisions control their direct expenses whilst Manufacturing is responsible for shared costs. In 2008, the Group did not allocate these shared costs between divisions in the day-to-day management of its businesses, and the way in which divisional results are presented reflects this. However, in order to provide a basis for market comparison, the results below also include an allocation of Manufacturing costs to the customer-facing divisions on a basis management considers to be reasonable.

		PRO FORMA	
	2008	2007	**Increase**
	£m	£m	**%**
Global Markets			
Global Banking & Markets	**(3,570)**	4,641	**(177)**
Global Transaction Services	**1,339**	1,198	**12**
Total Global Markets (excluding credit market write-downs and one-off items)	**(2,231)**	5,839	**(138)**
Regional Markets			
UK Retail & Commercial Banking	**3,283**	3,985	**(18)**
US Retail & Commercial Banking	**524**	1,143	**(54)**
Europe & Middle East Retail & Commercial Banking	**70**	463	**(85)**
Asia Retail & Commercial Banking	**(113)**	(20)	
Total Regional Markets	**3,764**	5,571	**(32)**
RBS Insurance	**780**	681	**15**
Group Manufacturing	**-**	-	**-**
Central items (excluding one-off items)	**(2,233)**	(1,777)	
Profit before credit market write-downs and one-off items	**80**	10,314	**(99)**
Credit market write-downs and one-off items	**(6,107)**	(1,026)	
Group operating (loss)/profit	**(6,027)**	9,288	**(165)**

Risk-weighted assets of each division were as follows:

	Basel II	Basel II
	31 December	1 January
	2008	2008
	£bn	£bn
Global Markets		
- Global Banking & Markets	**278.5**	211.9
- Global Transaction Services	**19.6**	16.8
Total Global Markets	**298.1**	228.7
Regional Markets		
- UK Retail & Commercial Banking	**152.5**	153.1
- US Retail & Commercial Banking	**78.0**	53.8
- Europe & Middle East Retail & Commercial Banking	**30.9**	30.3
- Asia Retail & Commercial Banking	**6.4**	4.9
Total Regional Markets	**267.7**	242.1
Other	**12.0**	15.3
	577.8	486.1

Global Markets
Global Banking & Markets

	2008	PRO FORMA 2007
	£m	£m
Net interest income from banking activities	**4,034**	2,214
Net fees and commissions receivable	**1,562**	2,351
Income from trading activities	**4,043**	4,407
Other operating income (net of related funding costs)	**575**	1,908
Trading asset write-downs	**(5,776)**	-
Non-interest income before credit market write-downs and one-off items*	**404**	8,666
Total income before credit market write-downs and one-off items*	**4,438**	10,880
Credit market write-downs and one-off items*	**(6,958)**	(1,776)
Total income	**(2,520)**	9,104
Direct expenses		
- staff costs	**2,687**	3,853
- other	**1,441**	1,113
- operating lease depreciation	**224**	365
	4,352	5,331
Contribution before impairment losses	**(6,872)**	3,773
Impairment losses excluding reclassified asset impairments	**3,177**	122
Reclassified asset impairments	**466**	-
Contribution	**(10,515)**	3,651
Allocation of manufacturing costs	**479**	448
Operating (loss)/profit	**(10,994)**	3,203
Operating (loss)/profit before credit market write-downs, one-off items and reclassified asset impairments	**(3,570)**	4,641
Analysis of income by product:		
Rates	**3,543**	2,524
Currencies	**1,697**	1,092
Commodities	**778**	17
Equities	**415**	1,169
Credit markets	**1,366**	2,740
Asset and portfolio management	**2,415**	3,338
Total income before credit market and trading asset write-downs and one-off items	**10,214**	10,880
Credit market write-downs and one-off items*	**(6,958)**	(1,776)
Trading asset write-downs	**(5,776)**	-
Total income	**(2,520)**	9,104
	£bn	£bn
Loans and advances (including banks)	**354.3**	254.1
Reverse repos	**96.1**	308.9
Securities	**163.2**	239.5
Cash and eligible bills	**26.1**	26.9
Other assets	**52.2**	44.4
Total third party assets (excluding derivatives mark to market)	**691.9**	873.8
Net derivative assets (after netting)	**146.0**	64.1
Customer deposits (excluding repos)	**105.0**	106.7
Non-performing loans	**6.2**	1.0

*includes fair value of own debt but excludes reclassified asset impairments

	31 December 2008 £bn	1 January 2008 £bn
Risk-weighted assets	**278.5**	211.9

While Global Banking & Markets produced good performances in a number of its businesses, most notably in rates and currencies, the turmoil in financial markets severely affected the division's results in 2008, with a particularly adverse impact in the fourth quarter. GBM incurred £5,776 million of losses, write-downs or reserves largely on credit trading, counterparty risk (including CDPCs), counterparty failure (notably Lehman and Madoff) and sovereign events as the effects of the down-turn widened. In addition, losses on previously identified credit market exposures totalled £7,781 million, including impairments of £466 million on reclassified assets (see Appendix 2). These were only partly offset by gains on the fair value of own debt.

Total income before these credit market write-downs and unusual items was £10,214 million, down 6% from 2007. After these items, GBM recorded negative income of £2,520 million. Although direct costs were cut by 18%, credit impairments rose sharply, resulting in a 2008 operating loss of £10,994 million.

Net interest income grew by 82% to £4,034 million, with the rates business benefiting from the declining interest rate environment. Before credit market write-downs, other one-off items and trading asset write-downs, non-interest income reduced by 29% to £6,180 million, with fees and commissions falling as origination volumes declined, and income from trading activities decreasing by 8% to £4,043 million. Other operating income fell sharply from £1,908 million to £575 million, reflecting losses incurred on European loan sales and much reduced gains on other portfolio assets, partially offset by the gain on sale of Angel Trains of £570 million.

By business line, the rates and currencies business achieved a particularly strong performance in 2008, with high volumes of customer activity and flow trading resulting in an 40% increase in income from rates trading to £3,543 million and 55% growth in currencies income to £1,697 million. The Sempra Commodities joint venture performed ahead of expectations in the nine months since its formation, with GBM's commodities income reaching £778 million for the year.

Equities saw reduced customer flow and also experienced losses on illiquid trading positions as markets deteriorated rapidly, leading to a drop in income from £1,169 million in 2007 to £415 million.

In a reduced market for debt origination, credit markets improved its market positions in a number of key areas such as international bond issuance. Results, however, were severely affected by the continuing market weakness, with income, even excluding write-downs on previously disclosed credit market exposures and one-off items, falling by 50% to £1,366 million.

Asset and portfolio management income remained resilient, but some losses were incurred, including on capital and credit exposure management, and income declined by 28% to £2,415 million.

Direct expenses were reduced by 18% to £4,352 million, with staff costs falling, despite the inclusion of Sempra, by 30% to £2,687 million, as a result of a sharp reduction in bonus payments. Non-staff expenses increased by 13%, principally reflecting increased transactional, legal and professional costs, inflation and foreign exchange movements, offset by reduced operating lease depreciation following the sale of Angel Trains.

Credit impairments increased sharply to £3,643 million, including £466 million on assets reclassified out of the held for trading category following the amendments to IAS 39 issued in October. Of the total impairment charge, £2,938 million was incurred in the fourth quarter of 2008, including £918 million relating to the Group's exposure to LyondellBasell.

GBM's total third party assets were reduced by £182 billion to £692 billion at 31 December 2008, a reduction of 21% from a year earlier, or 31% at constant exchange rates. Within this total, loans and advances to customers were £354 billion, an increase of 14% at constant exchange rates. This increase was more than offset by significant reductions in reverse repos and securities holdings, both of which have been managed down over the course of the year. Net derivative assets totalled £146 billion, compared with £64 billion at the end of 2007.

Although GBM took steps to reduce underlying risk-weighted assets, these measures were masked by the impact of foreign exchange movements and of Basel II pro-cyclicality, with the result that RWAs at 31 December 2008 totalled £279 billion, up 31% from a year earlier, or 14% at constant exchange rates.

Strategic Review

Following the review, GBM intends to focus its business around its core corporate and institutional customer set across the world. These clients are global in nature and are multi-product users. GBM will deploy capital and resources in support of this customer base and will continue to arrange and distribute credit (loans and bonds) and build sustained competitive advantage in its core financing, risk management and investment products, and flow trading businesses.

RBS is renewing its commitment to product areas where GBM has market-leading competitive positions across its customer–centric origination, advisory and trading activities. It has strong market positions in loans, bonds, FX, rates, commodities and equities and will drive these businesses, restructured where necessary, in a focused manner around customers' needs. GBM will discontinue all illiquid proprietary trading activities and correlation trading, in equity and credit markets. It will drastically scale back activity in structured real estate, leveraged and project finance, and exit lending in these areas entirely. All businesses, and notably GBM's asset finance businesses, will be managed within strict capital guidelines.

Globally, the intention is for GBM to move increasingly towards a "hub-and-spoke" model. Risk will be managed from regional hubs. It is intended that distribution and coverage will be delivered from a mix of hub countries and a scaled-back presence in some local offices. The aim, over time, will be to reduce much of the on-shore trading activity outside the key financial centres.

Assets, products and geographies that fit GBM's new client-focused proposition will be defined as "core" and will remain within the division. Assets, business lines and some geographies that are non-core will be transferred to the new Non-Core Bank. These non-core activities accounted for approximately £205 billion of third party assets at end 2008.

Global Markets
Global Transaction Services

	2008 £m	PRO FORMA 2007 £m
Net interest income	**909**	846
Non-interest income	**1,563**	1,359
Total income	**2,472**	2,205
Direct expenses		
- staff costs	**392**	367
- other	**202**	177
	594	544
Contribution before impairment losses	**1,878**	1,661
Impairment losses	**60**	15
Contribution	**1,818**	1,646
Allocation of manufacturing costs	**479**	448
Operating profit	**1,339**	1,198
Analysis of income by product:		
Domestic cash management	**761**	741
International cash management	**753**	644
Trade finance	**264**	168
Merchant acquiring	**577**	551
Commercial cards	**117**	101
Total income	**2,472**	2,205
	£bn	£bn
Total third party assets	**24.0**	22.5
Loans and advances	**18.6**	18.7
Customer deposits	**60.9**	56.8

	31 December 2008 £bn	1 January 2008 £bn
Risk-weighted assets	**19.6**	16.8

Global Transaction Services grew income by 12% to £2,472 million and operating profit by 12% to £1,339 million for the full year 2008, reflecting the strength and enhanced international capability of its cash management, trade finance and merchant acquiring platforms. The income growth rate was maintained in the second half of the year, despite difficult market conditions.

Growth was driven by a strong performance in cash management, where income rose 9% to £1,514 million with good growth in international cash management markets and steadier growth in UK and US domestic markets. Average customer deposits were 14% higher mitigating the impact of lower interest rates. International overdrafts have been re-priced, reflecting the increased cost of funds and higher risk premia during the second half of the year. Fee income from payment transactions increased strongly, particularly in the US and internationally. The division was successful throughout the year in winning new international cash management mandates from existing RBS Group clients due to the strength of the international payments platform and network.

Trade finance made good progress, with income continuing to grow strongly in the second half of the year and was up 57% for the full year. GTS has substantially improved its penetration into the Asia-Pacific market, increasing trade finance income in the region by 74%, and has expanded its supply chain finance activities with an enhanced product suite. Margins improved throughout the year reflecting the additional risk premium in the prevailing market conditions.

Merchant services and commercial cards delivered a 6% increase in income to £694 million. Acquiring transaction volumes were up 23% in the year driven by good growth in online volumes, but weaker consumer confidence in the latter part of the year meant that average transaction values decreased, slowing income growth. Commercial cards income saw strong second half growth of 26% and rose 16% for the full year, driven by higher interchange income particularly in the small and middle markets.

Direct expenses rose by 9% to £594 million, with second half cost growth lower than the first half. The full year cost growth reflected investment in staffing and infrastructure to support GTS's development.

Impairment losses were £60 million, up from £15 million in 2007, reflecting in particular the downturn in the global economy and some growth in defaults amongst mid-corporates and SMEs.

Strategic Review

GTS remains a strategically attractive business for RBS, providing important working capital and payment solutions to the Group's customers and substantial scope remains to cross-sell global transaction services to our corporate and financial institutional clients, particularly those in the UK. GTS plans to right-size its global network consistent with developing Europe as its core base, it will retain the capability to continue to serve both locally and globally all multi-national customers who are at the heart of the Core GBM proposition, whilst at all times maintaining service levels during the change. The business also plans to increase efficiency through development of a lower cost front and back-office operating model and explore joint ventures for growth and selective disposals.

Regional Markets
UK Retail & Commercial Banking

	2008 £m	PRO FORMA 2007 £m
Net interest income	**7,090**	6,668
Net fees and commissions - banking	**2,886**	3,030
Other non-interest income*	**838**	890
Non-interest income	**3,724**	3,920
Total income	**10,814**	10,588
Direct expenses		
- staff costs	**1,978**	1,919
- other	**1,193**	1,076
	3,171	2,995
Contribution before impairment losses	**7,643**	7,593
Impairment losses	**1,964**	1,368
Contribution	**5,679**	6,225
Allocation of manufacturing costs	**2,396**	2,240
Operating profit	**3,283**	3,985
	£bn	£bn
Total banking assets	**249.4**	232.8
Loans and advances to customers – gross		
- UK Retail Banking	**117.5**	111.0
- UK Corporate & Commercial Banking	**110.4**	99.3
- UK Wealth	**10.1**	8.4
Customer deposits**	**186.1**	189.4
AUMs – excluding deposits	**22.5**	25.8
Non-performing loans	**7.9**	5.5

	31 December 2008 £bn	1 January 2008 £bn
Risk-weighted assets	**152.5**	153.1

***** net of insurance claims; ****** excluding bancassurance

UK Retail and Commercial Banking retains an extremely strong franchise and represents the core of the RBS Group. However, the external environment over the next few years will present significant challenges with pressure on income as a result of very low interest rates, lower fee income, and impairment costs likely to increase further.

The business plans to respond to this environment through reducing costs and increasing productivity by investing in online service channels, automation of activities and re-design of end-to-end processes. The business will tailor the cost of service for different client segments more closely to their value generation.

Wealth management remains a strong growth opportunity and the business plans to pursue a more consolidated approach to the market through more co-ordination across the multiple brands with which it currently faces the market, whilst investing in additional Relationship Managers and platform functionality.

The division will pursue above market growth in customer deposits to improve its funding contribution to the Group, and will diversify its customer lending, reducing its exposure to commercial property.

UK Retail Banking

	2008 £m	PRO FORMA 2007 £m
Net interest income	**4,390**	4,172
Net fees and commissions - banking	**2,186**	2,351
Other non-interest income *	**218**	271
Non-interest income	**2,404**	2,622
Total income	**6,794**	6,794
Direct expenses		
- staff costs	**1,258**	1,266
- other	**574**	545
	1,832	1,811
Contribution before impairment losses	**4,962**	4,983
Impairment losses	**1,281**	1,184
Contribution	**3,681**	3,799
Allocation of manufacturing costs	**1,917**	1,792
Operating profit	**1,764**	2,007
Analysis of income by product:		
Personal advances (excl mortgages)	**2,061**	2,159
Mortgages	**505**	517
Personal deposits	**2,213**	2,070
Business advances	**583**	606
Business deposits	**706**	652
Bancassurance	**217**	270
Tesco Personal Finance	**285**	264
Other	**224**	256
Total income	**6,794**	6,794
	£bn	£bn
Loans and advances to customers – gross		
- mortgages	**74.9**	67.4
- personal	**16.2**	17.1
- cards	**6.4**	7.8
- business	**20.0**	18.7
Customer deposits**	**95.9**	96.1
AUMs – excluding deposits	**5.7**	7.0
Non-performing loans	**4.8**	4.3

	31 December 2008 £bn	1 January 2008 £bn
Risk-weighted assets	**63.8**	65.7

***** net of insurance claims;
****** excluding bancassurance

Despite an economic environment which became markedly weaker in the second half of the year, UK Retail Banking, which includes both personal and small business banking, held income and direct costs in line with 2007. However the deterioration in the macroeconomic environment resulted in an 8% increase in impairment losses. Consequently, operating profit decreased 12%, £243 million, to £1,764 million. In the personal segment, RBS retained top position and NatWest was again joint second for customer satisfaction amongst main high street banks. The business segment has continued to grow, maintaining market leadership with a share of 26%, alongside 23% of the start-up market. UK Retail continues to maintain availability of lending while managing risk exposure and focusing on supporting customers through a difficult economic environment.

Net interest income increased 5% to £4,390 million as a result of strong balance sheet growth. Net interest income performance in the personal segment was strong, up 7%, as a result of good volume growth coupled with improving new lending margins. The small business sector has seen more pressure on asset margins, from increased funding costs, which has restricted net interest income growth to 4%. Average loans and advances to customers increased 7% and average deposits were up 6% with personal savings growing 9% and small business deposits growing 3%. At year end deposit balances were in line with 2007 levels, reflecting increasing competitive pressure in a slowing market. Net interest margin reduced from 3.92% to 3.85%, reflecting increased funding and liquidity costs.

UK Retail mortgage balances grew 11% despite more muted demand in the second half, and net mortgage lending market share increased to 19% (2007: 2%). Small business lending grew 7% despite a significant contraction in demand. Personal unsecured lending slowed, however, particularly in the second half of the year. Further, the sale of Tesco Personal Finance (TPF) reduced personal unsecured balances at 31 December 2008 by £1.9 billion, though income of £285 million from TPF was included up to the date of the sale completion on 19 December.

Non interest income net of claims declined 8% to £2,404 million. Bancassurance sales grew 3% to £353 million annual premium equivalent in the year however the negative performance of debt and equity markets reduced investment income by £48 million. Excluding this, underlying non interest income declined 6% reflecting reduced demand for unsecured lending and lower sales of payment protection insurance.

Direct expenses increased 1% to £1,832 million. Direct staff costs reduced 1% reflecting increased efficiency. Other direct costs rose by 5% as a result of increased investment in selected business lines. During 2008 the division almost doubled the number of branches open on a Saturday and introduced 1,000 MoneySense advisers into branches to provide impartial advice to customers on managing their money.

Impairment losses increased 8% to £1,281 million, with an increase in small business delinquencies and personal impairments reflecting the changed economic environment, particularly in the second half. In the small business segment impairments increased to £158 million (2007: £80 million). In the personal segment the increase in impairments has been more modest, with mortgage impairment charges at £33 million (2007: £21 million) on a total book of £74.9 billion, while unsecured personal lending impairments remained level with 2007 at £1,091 million (2007: £1,084 million). Higher Loan-to-Value ratio mortgages have been restricted and affordability criteria tightened. The average LTV for new business was 67% (2007: 62%). Repossessions represented 0.06% of outstanding mortgage balances at 31 December 2008, compared with a Council of Mortgage Lenders' average at December 2008 of 0.21%.

Risk weighted assets totalled £63.8 billion at year end, a fall of 3% from 1 January 2008. The upward pressure from procyclicality, especially on the mortgage book, and book growth was offset by the disposal of TPF and improvements in Basel II methodologies.

UK Corporate & Commercial Banking

	2008 £m	PRO FORMA 2007 £m
Net interest income	**2,130**	1,990
Net fees and commissions	**450**	425
Other non-interest income	**581**	592
Non-interest income	**1,031**	1,017
Total income	**3,161**	3,007
Direct expenses		
- staff costs	**486**	431
- other	**529**	467
	1,015	898
Contribution before impairment losses	**2,146**	2,109
Impairment losses	**671**	180
Contribution	**1,475**	1,929
Allocation of manufacturing costs	**359**	336
Operating profit	**1,116**	1,593
Analysis of income by product:		
Corporate and commercial lending	**1,751**	1,710
Asset finance	**487**	477
Invoice finance	**78**	91
Corporate deposits	**424**	344
Other	**421**	385
Total income	**3,161**	3,007
	£bn	£bn
Loans and advances to customers – gross	**110.4**	99.3
Customer deposits	**64.3**	66.2
Non-performing loans	**3.0**	1.2

	31 December 2008 £bn	1 January 2008 £bn
Risk-weighted assets	**80.7**	80.5

UK Corporate & Commercial Banking experienced a solid performance in the first half of 2008, with the second half of 2008 being impacted by the marked deterioration in economic conditions. Total income increased 5% to £3,161 million and contribution before impairments increased by 2%. Growth in impairments, especially in the second half of the year, resulted in a 30% fall in operating profit to £1,116 million.

Net interest income increased 7% to £2,130 million. Average loans and advances were 18% higher than 2007, reflecting the Group's continuing support for the UK economy. New business margins widened in the second half to reflect increasing risk premia, however, higher funding costs on the back book suppressed growth in net interest income.

UK Corporate & Commercial Banking

Average deposit balances increased 3%. The deposit market continues to see acute competition in a number of sectors affecting margins. Overall net interest margin decreased from 2.39% to 2.15% due to increased funding and liquidity costs and strong growth in relatively lower margin Corporate products.

Non interest income increased 1% to £1,031 million. 2007 benefited from the profit on disposal of the Securities Services Group business; adjusting for this underlying growth in non interest income was 6%. This strong performance reflects increased sales of interest rate and currency risk management products.

Direct expenses increased 13% to £1,015 million, reflecting a 26% rise in operating lease depreciation to £401 million, due to higher volumes as well as additional provisions of £54 million for lower residual values in the Lombard vehicle leasing business. Direct expenses, excluding operating lease depreciation, increased by 6% to £614 million with cost growth reflecting the recruitment of additional relationship managers in 2007.

Impairment losses totalled £671 million, a sharp increase from the historically low levels seen in 2007. 48% of the charge related to house builder and property development companies. Losses were concentrated in the smaller end of the corporate sector, although a number of specific exposures in the larger corporate sector have also impacted the charge. The commercial businesses charge was £368 million (2007: £100 million) and the corporate business charge was £303 million (2007: £80 million).

The performance of our commercial property book remains under close watch. Average LTVs in the UK portfolio is 68% and less than 5% of the portfolio has LTVs greater than 85%.

RWA growth has been constrained by improvements in Basel II methodologies and active risk management, which have offset growth in the underlying balance sheet and the impacts of procyclicality.

UK Wealth	2008 £m	PRO FORMA 2007 £m
Net interest income	**570**	506
Net fees and commissions	**250**	254
Other non-interest income	**39**	27
Non-interest income	**289**	281
Total income	**859**	787
Direct expenses		
- staff costs	**234**	222
- other	**90**	64
	324	286
Contribution before impairment losses	**535**	501
Impairment losses	**12**	4
Contribution	**523**	497
Allocation of manufacturing costs	**120**	112
Operating profit	**403**	385
Analysis of income:		
Private Banking	**726**	657
Investments	**133**	130
Total income	**859**	787
	£bn	£bn
Loans and advances to customers – gross		
- mortgages	**5.2**	4.2
- personal	**3.7**	3.0
- other	**1.2**	1.2
Customer deposits	**25.9**	27.1
AUMs – excluding deposits	**16.8**	18.8
Non-performing loans	**0.1**	-

	31 December 2008 £bn	1 January 2008 £bn
Risk-weighted assets	**8.0**	6.9

UK Wealth delivered robust growth, with total income increasing by 9% to £859 million and operating profit increasing by 5% to £403 million.

UK Wealth generates earnings from both private banking and investment services, and this has enabled the division to maintain strong organic growth, despite the deterioration in global market conditions. Coutts & Co. performed particularly well, with contribution up by 15%.

UK Wealth

Average loans and advances to customers rose by 17% and average customer deposits by 11%, underpinning a 13% rise in net interest income to £570 million.

Non interest income grew by 3% to £289 million as higher fee income was offset by lower investment income. Although average assets under management were 4% higher than in 2007, lower stock market levels in the latter part of the year reduced assets under management by 11% to £16.8 billion.

Direct expenses rose by 13% to £324 million partly due to increased headcount and higher deposit protection scheme contributions.

Impairments rose from £4 million in 2007 to £12 million and represented approximately 0.1% of the total UK lending book.

Regional Markets
US Retail & Commercial Banking

	2008 £m	PRO FORMA 2007 £m	2008 $m	PRO FORMA 2007 $m
Net interest income	**2,106**	1,935	**3,902**	3,872
Net fees and commissions	**705**	687	**1,305**	1,375
Other non-interest income	**199**	159	**371**	317
Non-interest income	**904**	846	**1,676**	1,692
Total income	**3,010**	2,781	**5,578**	5,564
Direct expenses				
- staff costs	**675**	598	**1,250**	1,197
- other	**411**	364	**762**	728
	1,086	962	**2,012**	1,925
Contribution before impairment losses	**1,924**	1,819	**3,566**	3,639
Impairment losses – core	**722**	177	**1,337**	351
Impairment losses – SBO	**319**	163	**592**	329
Contribution	**883**	1,479	**1,637**	2,959
Allocation of manufacturing costs	**359**	336	**665**	672
Operating profit	**524**	1,143	**972**	2,287
Average exchange rate - US$/£	**1.853**	2.001		
Analysis of contribution:				
Retail	**499**	1,096	**926**	2,195
Commercial	**384**	383	**711**	764
	883	1,479	**1,637**	2,959
Analysis of income by product:				
Personal lending	**236**	212	**438**	425
Credit and debit cards	**261**	224	**484**	447
Mortgages and home equity	**468**	434	**868**	869
Retail deposits	**971**	991	**1,799**	1,982
Investment products	**61**	49	**113**	98
Commercial lending	**452**	367	**837**	734
Commercial deposits	**409**	364	**757**	729
Other	**152**	140	**282**	280
Total income	**3,010**	2,781	**5,578**	5,564
	£bn	£bn	**$bn**	$bn
Total assets	**103.9**	79.6	**151.8**	159.2
Loans and advances to customers – gross				
- mortgages	**10.7**	9.5	**15.7**	19.1
- home equity	**23.8**	17.9	**34.8**	35.9
- other consumer	**14.6**	10.8	**21.3**	21.6
- corporate and commercial	**28.2**	18.8	**41.2**	37.6
Customer deposits	**64.6**	52.8	**94.3**	105.8
Non-performing loans	**0.8**	0.3	**1.1**	0.6
Spot exchange rate - US$/£			**1.460**	2.004

	31 December 2008 £bn	1 January 2008 £bn	**31 December 2008 $bn**	1 January 2008 $bn
Risk-weighted assets	**78.0**	**53.8**	**113.9**	107.9

US Retail & Commercial Banking held income steady in 2008 at $5,578 million, but experienced a sharp increase in impairment losses as economic conditions progressively worsened over the course of the year. As a result, operating profit declined to $972 million, down 57%. In sterling terms, total income increased by 8% to £3,010 million while operating profit declined by 54% to £524 million.

Total income of $5,578 million was essentially unchanged, with 11% growth in commercial banking to $1,231 million offsetting a 2% decline in retail banking income to $4,347 million. Both segments were affected by the deterioration in credit conditions, with retail contribution down 58% to $926 million and commercial contribution down 7% to $711 million.

Overall, net interest income grew modestly, offset by a small decline in non-interest income. Average loans and advances to retail customers decreased as a result of the slowing economy and tighter underwriting standards, but this decline was offset by continued strong growth in corporate and commercial lending. Core customer deposits declined by 5% and the division further reduced its reliance on brokered deposits by 80%, leading to an overall decline of 11% in total customer deposits. Net interest margin was held steady at 2.73%, reflecting widening asset margins and management of savings rates in a competitive deposit market.

Direct expenses increased by 5% to $2,012 million, reflecting increased costs from the expansion of the commercial banking relationship management teams, write-downs on mortgage servicing rights, and higher costs related to loan work-out and collection activity.

Credit conditions worsened significantly over the course of the year as the housing market continued to deteriorate and unemployment rose, exacerbating already challenging conditions. Impairment losses totalled $1,929 million, up 184% from 2007 reflecting the deterioration in economic conditions.

In the core US Retail & Commercial portfolio, 2008 impairment losses totalled $1,337 million, with a marked increase in the second half. Consumer non-performing loans represented 0.37% of core home equity balances and 1.20% of residential mortgage balances. While there has been a decline in some customers' credit scores in line with weakening economic conditions, refreshed weighted average FICO scores for consumer real estate-secured lending at 31 December 2008 was approximately 740 with a weighted average LTV of 63%. Stress has emerged in all consumer segments during the second half of the year, with increased delinquency in core home equity (up 10bps to 0.86%), and auto (up 94bps to 2.78%). US Retail & Commercial does not originate negative amortization mortgages or option adjustable rate mortgages. Closing provision balances for the core portfolio were $1,303 million compared with $777 million at the end of 2007.

Credit quality has continued to deteriorate sharply in the externally sourced home equity portfolio (the Serviced By Others (SBO) portfolio). This portfolio, now managed by a separate work-out group and in run-off, has been reduced by $1.5 billion over the last year to $7.1 billion at 31 December 2008. Non-performing SBO loans represent 2.66% of SBO balances. Impairment losses in relation to the SBO portfolio totalled $592 million for 2008, with $268 million incurred in the second half of 2008 compared with $324 million in the first half. Closing SBO provision balances amounted to $474 million at 31 December 2008, up from $413 million at 30 June 2008, providing a coverage ratio of 2.5 times non-performing loans.

The overall commercial loan portfolio has begun to show signs of stress, with a marked deterioration in the commercial real estate book. Impairments in the commercial and industrial portfolio, including lease financing, totalled $212 million, or 0.74% of balances. Total impairments within the commercial real estate portfolio were $177 million, or 1.63% of balances.

The US business has continued to evaluate opportunities to optimise capital allocation by exiting or reducing exposure to lower growth or sub-scale segments. In the fourth quarter, 18 rural branches in the Adirondacks region were sold to Community Bank System. An agreement has also been announced to sell the Indiana retail branch banking network, consisting of 65 branches, and the business banking and regional banking activities, to Old National Bank.

Strategic Review

Citizens has a high quality retail and commercial banking franchise in the north eastern US. New England and the Mid Atlantic are attractive banking markets, and Citizens is well positioned in them in terms of market share and key local market coverage. The business intends to invest in this core business through increased marketing activity and targeted technology investments, whilst reducing activity in its out-of-footprint national businesses in consumer and commercial finance. This strategy will allow Citizens to become fully funded from its own customer deposits over time, and will support a low risk profile.

Regional Markets
Europe & Middle East Retail & Commercial Banking

	2008 £m	PRO FORMA 2007 £m
Net interest income	**1,152**	1,066
Net fees and commissions	**320**	265
Other non-interest income	**46**	107
Non-interest income	**366**	372
Total income	**1,518**	1,438
Direct expenses		
- staff costs	**404**	330
- other	**159**	173
	563	503
Contribution before impairment losses	**955**	935
Impairment losses	**526**	136
Contribution	**429**	799
Allocation of manufacturing costs	**359**	336
Operating profit	**70**	463
Analysis of contribution:		
Ulster Bank	**443**	733
Other Europe and Middle East	**44**	41
Discontinued operations	**(58)**	25
	429	799
Analysis of income by business:		
Ulster corporate	**732**	657
Ulster retail	**436**	418
Other	**350**	363
Total income	**1,518**	1,438
	£bn	£bn
Total assets	**66.4**	56.1
Loans and advances to customers – gross		
- mortgages	**24.6**	18.3
- corporate	**33.4**	25.3
- other	**3.7**	4.2
Customer deposits	**25.0**	22.3
Non-performing loans	**3.3**	0.7

	31 December 2008 £bn	1 January 2008 £bn
Risk-weighted assets	**30.9**	30.3

The significant deterioration in global and local market conditions has impacted the main Europe & Middle East markets, with operating profit falling to £70 million, 85% lower than in 2007. The main driver of this reduction has been an increase of £390 million in impairments, albeit from a low base, reflecting deterioration in credit quality particularly in the property and construction sectors, as economic conditions have slowed. Operating profit excluding impairment losses held steady at £596 million.

Total income was up £80 million, 6% to £1,518 million benefiting from movements in exchange rates. Adjusting for this, income declined by 5%. While average loans and deposits grew by 25% and 13% respectively net interest margin reduced by 21bps in the year to 2.02%, impacted primarily by higher funding costs and the effect of discontinued businesses. Direct expenses were up 12% to £563 million. At constant exchange rates direct expenses were flat reflecting the benefit of cost saving initiatives. Impairment losses rose to £526 million from £136 million reflecting the economic environment.

In sterling terms the results have been materially affected by the movement in the Euro exchange rate and references to percentage movement in the following analysis are in constant currency terms.

Ulster Bank operating profit fell 76% to £117 million. Total income decreased by 2% to £1,269 million; net interest income increased by 1%, with average loans and advances to customers up 12% in the year. The benefit from the growth in lending, particularly in the first half of the year has been offset by increased funding costs associated with the wholesale funding market dislocation. Other income was 12% lower than in 2007, reflecting a slowdown in particular in the bancassurance and wealth businesses.

Average mortgage balances in Ulster Bank were 11% higher than 2007. New mortgage volumes in the second half of the year were significantly lower than in the first six months, although levels of redemptions have also fallen.

Average deposit balances in Ulster Bank were largely flat year-on-year reflecting the highly competitive market for resources in Ireland in 2008. Deposit flows in Ulster Bank were strong in the latter part of the year and into the early months of 2009. During 2008, we opened 119,000 new current accounts driven by particularly successful current account switcher and student campaigns.

Direct expenses rose by 8% to £432 million, reflecting the full year impact of the now completed investment programme in Ulster Bank's footprint and operations. Cost growth in the second half of 2008 was significantly lower, reflecting disciplined management of the cost base.

Impairment losses in Ulster Bank rose to £394 million, reflecting the impact on credit quality of the slowdown in the Irish economy, with the final quarter showing notable decline in both activity and sentiment. This was reflected in a significantly increased flow of cases into the problem debt management process.

In January 2009, Ulster Bank announced its intention to adopt a single brand strategy under the Ulster Bank brand. This will see the merger of the operations of Ulster Bank and First Active in the Republic of Ireland ("RI") by the end of 2009. This action is being taken to strengthen the Ulster Bank Group franchise by positioning it to deal with the prevailing local and global market conditions. A number of cost management initiatives have also commenced across the business.

Ulster Bank has launched a series of initiatives to support its customers in this difficult economic period. We announced in February 2009 that we will be making significant funds available to the Northern Ireland ("NI") SME market. A similar announcement will be made in the coming weeks regarding the RI SME market. Ulster Bank has also indicated that it is adopting the RBS Group pledge regarding certainty of overdraft limits for this sector.

The Momentum and Secure Step mortgages have been launched in NI and RI respectively to support First Time Buyers and the Bank has confirmed its pledge of a six-month moratorium to mortgage customers facing potential repossession. In support of our retail customers across the island of Ireland, the Group's MoneySense programme is being rolled out, with trained advisers being introduced to all Ulster Bank branches.

Outside Ireland, Europe & Middle East Retail & Commercial Banking continued to trade satisfactorily, although our markets in the United Arab Emirates, Romania and Kazakhstan have also experienced a marked slowdown in the past year. In UAE, where we are a market leader in credit cards with over 430,000 cards in issue, credit card revenue increased 22% in the year.

The sale of the European Consumer Finance business to Santander was completed on 1st July 2008, while the Imagine business in Spain was sold to Bank of America in the second half of 2008. The former ABN retail business in Russia was also closed during the year.

Strategic Review

Ulster Bank, which remains a core part of the Group's global banking operations, has a strong franchise in both Northern Ireland, where it is the leading bank, and the Republic of Ireland where it is overall the third-positioned bank. It has the product and distribution capability to grow profitably and well in normal market conditions. However, the economic difficulties that the Irish markets currently face are expected to persist for some time. Ulster Bank has been pro-active in responding to these market conditions through a programme of initiatives. The business plans to manage its balance sheet over the medium term, with particular focus on reducing risk concentrations as market conditions allow, whilst increasing and diversifying its customer deposit base.

The E&ME Retail and Commercial franchises outside of Ireland lack scale and breadth. They would require a very significant investment of capital and management resource to be able to achieve levels of shareholder return equivalent to those possible from more established core franchises in the Group. The Retail and Commercial businesses in E&ME outside of Ireland will be transferred to the non-core division. We have commenced a review to consider future options for these businesses, including options for sale.

Regional Markets
Asia Retail & Commercial Banking

	2008 £m	PRO FORMA 2007 £m
Net interest income	**379**	294
Net fees and commissions	**309**	338
Other non-interest income	**93**	63
Non-interest income	**402**	401
Total income	**781**	695
Direct expenses		
- staff costs	**284**	237
- other	**199**	135
	483	372
Contribution before impairment losses	**298**	323
Impairment losses	**171**	119
Contribution	**127**	204
Allocation of manufacturing costs	**240**	224
Operating loss	**(113)**	(20)
Analysis of income:		
Private banking	**301**	254
Cards and consumer finance	**232**	193
Affluent banking (and general)	**174**	190
Business & commercial banking	**74**	58
	781	695
	£bn	£bn
Total assets	**8.3**	7.6
Loans and advances to customers – gross	**5.8**	4.5
AUMs – excluding deposits	**21.2**	19.9
Customer deposits	**15.1**	10.8
Non-performing loans	**0.3**	0.5

	31 December 2008 £bn	1 January 2008 £bn
Risk-weighted assets	**6.4**	4.9

Asia Retail & Commercial Banking increased income by 12% to £781 million, but the continued deterioration in market conditions during the second half of the year resulted in an operating loss of £113 million. Comparisons with the previous year are affected by the marked weakening of sterling over the course of the year.

Affluent banking income slowed markedly in the second half of 2008 due to reduced structured product and equity fund sales, as investors stayed out of volatile markets. Despite this, Royal Preferred Banking client numbers have increased by 13% and assets under management in the affluent segment have increased by 3%.

Credit cards and consumer finance credit metrics have continually been reviewed over the period resulting in further tightening of consumer lending policies. This has led to lower levels of card and loan acquisition. There has also been a slowdown in the number of card transactions. Despite this, the cards and consumer finance business reported income growth of 20% with a corresponding increase in consumer net receivables.

Business banking has seen strong growth across most regions with revenue increasing by 28%, having performed particularly well in the Indian, Pakistani and Chinese markets.

RBS Coutts' offering of private banking and investment services continued to deliver good income growth of 19% and strong levels of client acquisition, up 5% in the year. Net interest income grew 56% on the back of strong banking volumes, though this was offset in part by weaker sales of equity-related investment products and lower assets under management. Despite adverse financial markets and significant levels of client deleveraging, assets under management in the international wealth business grew by 8%.

Total assets under management for the division at 31 December 2008 were 7% higher than a year earlier at £21.2 billion, while customer deposits were 40% higher at £15.1 billion, partly reflecting exchange rate movements.

Direct expenses rose by 30% to £483 million, reflecting higher collection costs and continued investment in the Group's infrastructure in the region, including the recruitment of additional experienced private bankers in RBS Coutts Asia.

Impairments increased by 44% to £171 million, reflecting an increase in provisioning levels across a number of consumer finance markets in the region.

Strategic Review

Asia Retail & Commercial Banking has operations in a number of countries across the region. However the franchise is thinly spread and in general has not yet achieved significant scale. The Retail and Commercial businesses in Asia will be transferred to the non-core division. We have commenced a review to consider future options for these businesses, including options for sale. RBS Coutts will remain a core business.

RBS Insurance

	2008 £m	PRO FORMA 2007 £m
Earned premiums	**5,520**	5,607
Reinsurers' share	**(227)**	(220)
Insurance premium income	**5,293**	5,387
Net fees and commissions	**(401)**	(465)
Other income	**674**	734
Total income	**5,566**	5,656
Direct expenses		
- staff costs	**309**	297
- other	**462**	444
	771	741
Gross claims	**3,857**	4,091
Reinsurers' share	**(124)**	(81)
Net claims	**3,733**	4,010
Contribution before impairment losses	**1,062**	905
Impairment losses	**42**	-
Contribution	**1,020**	905
Allocation of manufacturing costs	**240**	224
Operating profit	**780**	681
Analysis of income by product:		
Motor own-brands	**1,954**	1,974
Household and Life own-brands	**811**	728
Motor partnerships and broker	**1,278**	1,426
Household and Life, Partnerships and broker	**604**	641
Other (International, commercial and central)	**919**	887
Total income	**5,566**	5,656
In-force policies (thousands)		
- Own-brand motor	**6,964**	6,713
- Own-brand non-motor (home, rescue, pet, HR24)	**5,642**	3,752
- Partnerships & broker (motor, home, rescue, SMEs, pet, HR24)	**8,450**	9,302
General insurance reserves – total (£m)	**8,159**	8,192

RBS Insurance made good progress in 2008, with operating profit rising by £99 million to a record £780 million, an increase of 15%. Excluding the net impact of the 2007 floods and prior year reserve releases, operating profit grew by 6%. Total income was £90 million lower at £5,566 million, reflecting a fall in insurance premium income following the continuation of the strategic decision to exit less profitable partnership contracts and the effect of financial market conditions on investment income.

Own-brand businesses increased income by 4% and contribution before impairments by 13%. In the UK motor market the Group increased premium rates to offset claims inflation and continued to target lower risk drivers, with price increases concentrated in higher risk categories in order to improve profitability. During 2008 selected brands were successfully deployed on a limited number of aggregator web sites. Our international businesses in Spain, Italy and Germany performed well, with income up 24% and contribution up 37%. Over the last year own-brand motor policy numbers have again begun to increase, and rose by 4% to 7.0 million.

In own-brand non-motor insurance we have continued to achieve good sales through the RBS Group, where home insurance policies in force have increased by 33%. In addition, Privilege and Churchill have grown home policies by 90% and 13% respectively compared with 2007, mainly due to an increase in online sales as a result of successful marketing campaigns. A new commercial insurance offering, Direct Line for Business, was launched, and has grown rapidly over the year with particularly strong performances in Residential Property and Tradesman policies. Overall own-brand non-motor policies in force have grown by 50% to 5.6 million, benefiting from the addition of rescue cover to RBS and NatWest current account package customers.

Results from partnerships and broker business confirmed the Group's strategy of refocusing on the more profitable opportunities in this segment, where we provide underwriting and processing services to third parties. The Group did not renew a number of rescue contracts and pulled back from some less profitable segments of the broker market. As a result partnership and broker in-force policies have fallen by 9% over the last year with a corresponding 9% reduction in income, yet contribution grew by 27%.

For RBS Insurance as a whole, insurance premium income, net of fees and commissions, was broadly maintained at £4,892 million, reflecting 7% growth in the Group's own brands offset by a 10% decline in the partnerships and broker segment. Other income declined by 8% to £674 million, reflecting the effect of depressed financial markets on investment income.

Direct expenses grew by 4% to £771 million, in part as a result of accelerated marketing development in own brands, including the launch of Direct Line for Business.

Net claims fell by 7% to £3,733 million, benefiting from ongoing claims containment and more benign weather conditions. Impairments of £42 million reflect impairments recognised in corporate bond and equities investment portfolios.

The UK combined operating ratio for 2008, including manufacturing costs, decreased to 93.8% from 98.0%.

Strategic Review

The Group has decided to retain RBS Insurance, reflecting the strength of its franchise as the leading UK personal lines insurer. It provides high quality earnings, which are differentiated from the Group's banking businesses, providing valuable diversity and strong returns. The business plans to pursue additional growth opportunities through building its position in the online insurance aggregator channel, through the bank channels and in the commercial market. The business retains competitive advantage through its market leading brands, low cost operating model and the benefits of scale on its claims costs.

Group Manufacturing

	2008 £m	PRO FORMA 2007 £m
Staff costs	**1,197**	1,221
Other costs	**3,596**	3,260
Total manufacturing costs	**4,793**	4,481
Allocated to divisions	**(4,793)**	(4,481)
	-	**-**
Analysis of manufacturing costs:		
Technology Services and support functions	**1,757**	1,717
Group Property	**1,690**	1,485
Global Operations	**1,346**	1,279
Total manufacturing costs	**4,793**	4,481

Group Manufacturing costs have increased by 7% to £4,793 million in 2008. At constant exchange rates, costs rose by 2%.

Increasing business volumes have been absorbed through improvements in productivity. Group Manufacturing has maintained high levels of customer satisfaction while continuing to invest in the further development of the business. Staff costs reduced by 2% (7% reduction at constant exchange rates) primarily reflecting improvements in productivity.

Technology Services and support functions costs increased by 2% (reduced by 3% at constant exchange rates) with increases in business demand balanced by savings delivered across the business.

Group Property costs rose by 14% (8% at constant exchange rates), reflecting further development of the Group's Corporate Banking branch network as well as investment in Manufacturing infrastructure.

Global Operations costs increased by 5% (2% at constant exchange rates). Further improvements in productivity enabled us to continue to absorb increases in volumes and global inflationary pressure. Ongoing investment in process re-engineering across our operational centres under the 'Work-Out' banner continues to deliver efficiency gains.

Central items

	2008 £m	PRO FORMA 2007 £m
Funding costs	**1,331**	1,203
Departmental costs	**665**	620
Other corporate costs	**(4)**	(271)
	1,992	1,552
Allocation of manufacturing costs	**241**	225
Total central items*	**2,233**	1,777

*excluding one-off items (see Note 2 on page 53)

Central costs increased by 26% to £2,233 million.

Funding costs rose by £128 million, 11% to £1,331 million primarily due to higher cost of funds including those relating to the Bank of England Special Liquidity Scheme. The Group seeks to hedge its interest rate risk economically, and it is not always possible to achieve hedge accounting in accordance with IFRS. The movements in interest rates, currencies and inflation indices, particularly in the latter part of 2008, resulted in volatility for accounting purposes, leading to a charge of £204 million compared with a credit of £102 million in 2007. These costs were largely offset by increased dividends from Bank of China and benefits from the additional capital raised during the year.

Departmental costs rose by 7% to £665 million, reflecting an increase in central function headcount as well as higher Basel II costs and audit fees.

Other corporate items amounted to a net credit of £4 million, compared with a net credit of £271 million in 2007. The reduction reflects the Financial Services Compensation Scheme levy of £150 million and gains realised in 2007.

Credit market exposures

The write-downs before tax included in the Group's results for the year ended 31 December 2008 are as follows.

	2008			2007	
	Net exposure (1) £m	**Write-downs before tax £m**	**Average price %**	Net exposure (1) £m	Average price %
Asset-backed CDOs					
High grade	**1,231**	**1,836**	**29**	2,581	84
Mezzanine	**144**	**1,140**	**6**	1,253	70
	1,375	**2,976**		3,834	79
Exposures to financial guarantors					
Monoline exposures	**4,804**	**3,557**	**n/a**	2,547	n/a
US residential mortgages (2)					
Sub-prime (2)	**-**	**353**	**n/a**	1,292	72
Alt-A	**-**	**1,071**	**n/a**	2,233	83
Other non-agency	**-**	**43**	**n/a**	794	94
	-	**1,467**		4,319	81
US commercial mortgages (2)	**437**	**95**	**87**	1,809	97
Leveraged finance (3)					
Held-for-trading	**103**	**1,088**	**64%**	11,992	96%
Loans and receivables	**5,920**	**-**	**n/a**	2,514	n/a
		1,088		14,506	
CLOs	**520**	**240**	**81**	1,386	93
		9,423			
CDS hedging		**(1,642)**			
Total net of CDS hedging		**7,781**			

Notes:

(1) Net of hedges and write-downs.
(2) Held-for-trading portfolios only; includes investment grade, non-investment grade and residuals.
(3) Includes commitments to lend.

Refer to Appendix 2 for further analysis and discussion.

Average balance sheet – pro forma

	2008			2007		
	Average balance £m	Interest £m	Rate %	Average balance £m	Interest £m	Rate %
Assets						
Loans and advances to banks	**47,383**	**2,250**	**4.75**	49,384	2,389	4.84
Loans and advances to customers	**596,066**	**35,085**	**5.89**	511,573	32,426	6.34
Debt securities	**93,723**	**4,607**	**4.92**	50,427	2,819	5.59
Interest-earning assets – banking business	**737,172**	**41,942**	**5.69**	611,384	37,634	6.16
Trading business	**425,454**			449,140		
Non-interest-earning assets	**661,549**			372,688		
Total assets	**1,824,175**			1,433,212		
Liabilities						
Deposits by banks	**155,922**	**6,369**	**4.08**	149,579	6,705	4.48
Customer accounts	**386,334**	**13,119**	**3.40**	364,747	15,358	4.21
Debt securities in issue	**217,306**	**9,351**	**4.30**	134,183	7,130	5.31
Subordinated liabilities	**34,867**	**1,782**	**5.11**	26,639	1,466	5.50
Internal funding of trading business	**(103,754)**	**(4,174)**	**4.02**	(116,870)	(5,269)	4.51
Interest-bearing liabilities – banking business	**690,675**	**26,447**	**3.83**	558,278	25,390	4.55
Trading business	**466,610**			463,230		
Non-interest-bearing liabilities						
- demand deposits	**34,021**			32,469		
- other liabilities	**574,325**			334,841		
Shareholders' equity	**58,544**			44,394		
Total liabilities and shareholders' equity	**1,824,175**			1,433,212		

Notes:

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

(2) Interest-earning assets and interest-bearing liabilities exclude the Retail bancassurance assets and liabilities, in view of their distinct nature. As a result, interest income has been adjusted by £84 million (2007 - £85 million).

(3) Changes in the fair value of interest-bearing financial instruments designated as at fair value through profit or loss are recorded in other operating income in the consolidated income statement. In the average balance sheet shown above, interest includes interest income and interest expense related to these instruments of £332 million (2007 - £313 million) and £860 million (2007 - £536 million) respectively and the average balances have been adjusted accordingly.

(4) The 2007 data have been restated to reflect the finalisation of the purchase accounting adjustments in respect of ABN AMRO and the netting of certain derivative contracts.

Average balance sheet – pro forma (continued)

Average yields, spreads and margins of the banking business	**2008 %**	2007 %
Gross yield on interest-earning assets of banking business	**5.69**	6.16
Cost of interest-bearing liabilities of banking business	**(3.83)**	(4.55)
Interest spread of banking business	**1.86**	1.61
Benefit from interest-free funds	**0.24**	0.39
Net interest margin of banking business	**2.10**	2.00

Average interest rates	**2008 %**	2007 %
The Group's base rate	**4.67**	5.51
London inter-bank three month offered rates:		
- Sterling	**5.51**	6.00
- Eurodollar	**2.92**	5.29
- Euro	**4.63**	4.28

Net interest margin by division	**2008 %**	2007 %
Global Banking & Markets	**1.19**	0.75
Global Transaction Services	**7.01**	7.94
UK Retail & Commercial Banking	**3.21**	3.39
- UK Retail Banking	**3.85**	3.92
- UK Corporate & Commercial Banking	**2.15**	2.39
- UK Wealth	**6.17**	6.39
US Retail & Commercial Banking	**2.73**	2.74
Europe & Middle East Retail & Commercial Banking	**2.02**	2.23
Asia Retail & Commercial Banking	**6.14**	5.57

Condensed consolidated balance sheet
at 31 December 2008 – pro forma

	2008 £m	2007 £m
Assets		
Cash and balances at central banks	**11,830**	14,240
Net loans and advances to banks	**70,637**	36,556
Reverse repurchase agreements	**58,771**	174,444
Loans and advances to banks	**129,408**	211,000
Net loans and advances to customers	**691,876**	558,075
Reverse repurchase agreements and stock borrowing	**39,289**	142,116
Loans and advances to customers	**731,165**	700,191
Debt securities	**253,098**	240,801
Equity shares	**22,094**	46,704
Settlement balances	**17,812**	16,533
Derivatives	**991,493**	275,146
Intangible assets	**16,386**	27,610
Property, plant and equipment	**17,169**	16,913
Deferred taxation	**5,409**	1,680
Prepayments, accrued income and other assets	**20,715**	16,631
Assets of disposal groups	**67**	395
	2,216,646	1,567,844
Consortium share of shared assets	**2,047**	27,222
Total assets	**2,218,693**	1,595,066
Liabilities		
Deposits by banks	**178,268**	141,637
Repurchase agreements and stock lending	**83,666**	161,862
Deposits by banks	**261,934**	303,499
Net customer accounts	**460,318**	437,060
Repurchase agreements and stock lending	**58,143**	120,062
Customer accounts	**518,461**	557,122
Debt securities in issue	**269,188**	220,577
Settlement balances and short positions	**54,264**	89,829
Derivatives	**969,396**	270,814
Accruals, deferred income and other liabilities	**23,453**	27,873
Retirement benefit liabilities	**1,547**	265
Deferred taxation	**2,930**	3,728
Insurance liabilities	**7,480**	7,650
Subordinated liabilities	**43,678**	28,052
Liabilities of disposal groups	**-**	6
	2,152,331	1,509,415
Consortium share of shared assets	**2,047**	27,222
Total liabilities	**2,154,378**	1,536,637
Equity:		
Minority interests	**5,436**	5,391
Owners' equity*	**58,879**	53,038
Total equity	**64,315**	58,429
Total liabilities and equity	**2,218,693**	1,595,066
***Owners' equity attributable to:**		
Ordinary shareholders	**45,525**	44,684
Other equity owners	**13,354**	8,354
	58,879	53,038

Overview of condensed consolidated balance sheet – pro forma

Total assets of £2,218.7 billion at 31 December 2008 were up £623.6 billion, 39%, compared with 31 December 2007. At constant exchange rates the increase was £313 billion or 16%

Loans and advances to banks decreased by £81.6 billion, 39%, to £129.4 billion. Reverse repurchase agreements and stock borrowing ("reverse repos") were down by £115.7 billion, 66% to £58.8 billion. Excluding reverse repos, bank placings increased by £34.1 billion, 93%, to £70.6 billion.

Loans and advances to customers were up £31.0 billion, 4%, at £731.2 billion. Within this, reverse repos decreased by 72%, £102.8 billion to £39.3 billion. Excluding reverse repos, lending rose by £133.8 billion, 24% to £691.9 billion reflecting both organic growth of £44.8 billion, 7% and the effect of exchange rate movements of £89.0 billion following the weakening of sterling during the second half of 2008.

Debt securities increased by £12.3 billion, 5%, to £253.1 billion and equity shares decreased by £24.6 billion, 53%, to £22.1 billion principally due to changes in Global Banking & Markets.

Movements in the value of derivatives, assets and liabilities, primarily reflect changes in interest and exchange rates, together with an 7% growth in trading volumes on a constant currency basis.

Intangible assets declined by £11.2 billion, 41% to £16.4 billion, reflecting an impairment of £16.9 billion partially offset by exchange rate movements of £5.7 billion and goodwill of £0.2 billion arising on the Sempra joint venture.

Deferred tax assets increased £3.7 billion, to £5.4 billion principally due to carried forward trading losses.

Prepayments, accrued income and other assets were up £4.1 billion, 25% to £20.7 billion.

Deposits by banks declined by £41.6 billion, 14% to £261.9 billion. This reflected decreased repurchase agreements and stock lending ("repos"), down £78.2 billion, 48% to £83.7 billion partly offset by increased inter-bank deposits, up £36.6 billion, 26% to £178.3 billion.

Customer accounts were down £38.7 billion, 7% to £518.5 billion. Within this, repos decreased £61.9 billion, 52% to £58.1 billion. Excluding repos, deposits rose by £23.3 billion, 5%, to £460.3 billion.

Settlement balances and short positions were down £35.6 billion, 40%, to £54.3 billion reflecting reduced customer activity.

Accruals, deferred income and other liabilities decreased £4.4 billion, 16%, to £23.5 billion.

Retirement benefit liabilities increased £1.3 billion to £1.5 billion due to reduced asset values only partly offset by the effect of increased discount rates.

Deferred taxation liabilities decreased by £0.8 billion, 21% to £2.9 billion due in part to the sale of Angel Trains.

Subordinated liabilities were up £15.6 billion, 56% to £43.7 billion reflecting the issue of £2.0 billion dated loan capital, the allocation of £6.5 billion ABN AMRO subordinated liabilities from consortium shared assets, and the effect of exchange rate and other adjustments, £8.1 billion, partially offset by the redemption of £1.0 billion of dated loan capital.

Equity minority interests increased by 1% to £5.4 billion. Attributable profits of £0.4 billion, £0.8 billion equity raised as part of the Sempra joint venture and other equity raised, £0.3 billion, and the effect of exchange rate movements of £1.2 billion were partially offset by equity withdrawals of £0.9 billion, reductions in the market value of available-for-sale securities of £1.3 billion in respect of the investment in Bank of China attributable to minority shareholders, and dividends paid of £0.3 billion.

Owners' equity increased by £5.8 billion, 11% to £58.9 billion. Net proceeds of £12.0 billion from the rights issue, and net proceeds of £19.7 billion from the placing and open offer, together with exchange rate movements of £6.8 billion were partially offset by the attributable loss for the period of £23.5 billion, a £4.6 billion decrease in available-for-sale reserves, net of tax, reflecting £1.0 billion in the Group's share in the investment in Bank of China and £3.6 billion in other securities, the majority of which related to Global Banking & Markets, actuarial losses net of tax of £1.3 billion, the payment of the 2007 final ordinary dividend of £2.3 billion and other dividends of £0.6 billion, and a reduction in the cash flow hedging reserve of £0.3 billion.

Notes to pro forma results

1. Basis of preparation

The pro forma financial information shows the underlying performance of the Group including the results of the ABN AMRO businesses to be retained by the Group. This information is being provided to give a better understanding of what the results of the operations might have looked like had the acquisition of ABN AMRO as well as the transfers of businesses to the other Consortium Members occurred on 1 January 2007.

Group operating profit on a pro forma basis:

Excludes

- ABN AMRO pre acquisition credit market write-downs and the impact of the LaSalle sale;
- RBS share of ABN AMRO's shared assets;
- amortisation of purchase accounting adjustments in 2007
- amortisation of purchased intangible assets
- write-down of goodwill and other intangible assets
- integration costs; and

Includes

- the cost of funding the ABN AMRO acquisition within Central items. Whilst part of the acquisition consideration was funded by the issue of preference shares, the pro forma results for 2007 assume that the cash element of the consideration was debt funded. The results for 2008 reflect the actual amounts of interest and dividends on preference shares.

In the presentation of the pro forma income statement credit market write-downs, goodwill payments in respect of current account administration fees and the gains on sale of Southern Water in 2007 and certain other assets have been shown in aggregate in income and expenses as appropriate.

2. Credit market write-downs and one-off items

	2008	2007
	£m	£m
Global Banking & Markets:		
Credit market write-downs	**(7,315)**	(2,387)
Reclassified asset impairments	**(466)**	-
Gain on sale of Southern Water	**-**	712
Fair value of own debt	**357**	237
Centre:		
Fair value of own debt	**875**	152
Gain on sale of investment in Tesco Personal Finance	**442**	-
Gains on property sales and leasebacks	**-**	302
Goodwill payments in respect of current account administration fees	**-**	(119)
Other one-off items	**-**	77
	(6,107)	(1,026)
Income	**(5,641)**	(1,268)
Costs	**-**	242
Impairment	**(466)**	-
	(6,107)	(1,026)

3. Reclassification of financial instruments

Following the amendments to IAS 39 'Financial Instruments: Recognition and Measurement' in October 2008, the Group has reclassified out of the held-for-trading category certain loans and debt securities, for which no active market existed in 2008, and which the Group intends to hold for the foreseeable future. As a result of the reclassification, income for the second half of 2008 was £5.8 billion higher than would have been the case had the reclassification not taken place; this was offset by impairment losses of £466 million on debt securities reclassified as available-for-sale. In addition, £2.1 billion was charged to available-for-sale reserve reflecting a reduction in the fair value of these securities.

Further details including the balance sheet values are shown in Appendix 2.

4. Write-down of goodwill and other intangible assets

	2008 **£m**
Impairment of goodwill arising on the acquisition of:	
ABN AMRO	**7,678**
Citizens/Charter One	**4,382**
NatWest	**2,742**
First Active	**588**
Other	**132**
	15,522
Other intangible assets	**1,389**
	16,911

5. Loan impairment provisions

Operating loss is stated after charging loan impairment losses of £6,478 million (2007 - £2,082 million). The balance sheet loan impairment provisions increased in the year ended 31 December 2008 from £4,956 million to £9,451 million, and the movements thereon were:

	2008 **£m**	2007 £m
At 1 January	**4,956**	4,501
Currency translation and other adjustments	**1,023**	56
Acquisitions	**-**	129
Disposals	**(178)**	-
Amounts written-off	**(2,897)**	(1,914)
Recoveries of amounts previously written-off	**261**	275
Charge to the income statement	**6,478**	2,082
Unwind of discount	**(192)**	(173)
	9,451	4,956

Provisions at 31 December 2008 include £127 million (2007 - £3 million) in respect of loans and advances to banks.

6. Analysis of contingent liabilities and commitments

	2008 £m	2007 £m
Contingent liabilities		
Guarantees and assets pledged as collateral security	**45,931**	40,712
Other contingent liabilities	**21,765**	14,655
	67,696	55,367
Commitments		
Undrawn formal standby facilities, credit lines and other commitments to lend	**349,417**	321,093
Other commitments	**6,876**	2,639
	356,293	323,732
Total contingent liabilities and commitments	**423,989**	379,099

Additional contingent liabilities arise in the normal course of the Group's business. It is not anticipated that any material loss will arise from these transactions.

7. Taxation

The credit for taxation represents 15.7% (2007 – 19.1% charge) of (loss)/profit before tax. It differs from the tax charge computed by applying the standard UK corporation tax rate of 28.5% as follows:

	2008 £m	2007 £m
(Loss)/profit before tax	**(8,127)**	8,962
Expected tax (credit)/charge at 28.5% (2007 – 30%)	**(2,316)**	2,689
Non-deductible goodwill impairment	**-**	12
Unrecognised timing differences	**274**	29
Other non-deductible items	**323**	222
Non-taxable items	**(491)**	(595)
Foreign profits taxed at other rates	**271**	(99)
Reduction in deferred tax liability following change in the rate of UK Corporation Tax	**-**	(189)
Losses in year not recognised	**942**	2
Other	**69**	5
Adjustments in respect of prior periods	**(352)**	(367)
Actual tax (credit)/charge	**(1,280)**	1,709

8. Earnings per share

Earnings per share have been calculated assuming that the 6.1 billion ordinary shares issued following the rights issue of 11 new ordinary shares for every 18 held were issued on 1 January 2007. Earnings for 2007 have not been adjusted to reflect any income from the net proceeds of the rights issue of £12 billion received in June 2008 or from the placing and open offer of £15 billion in December 2008; earnings for 2008 include income earned from the date of receipt of the proceeds.

	2008 **£m**	2007 £m
Earnings		
(Loss)/profit attributable to ordinary shareholders	**(24,051)**	6,823
Weighted average number of ordinary shares (millions)		
In issue during the period	**39,436**	16,703
Basic (loss)/earnings per share	**(61.0p)**	40.8p
Credit market write-downs and one-off items	**10.8p**	2.4p
Intangibles amortisation	**0.9p**	0.6p
Write-down of goodwill and other intangible assets	**41.1p**	-
Restructuring costs	**0.6p**	-
Integration costs	**1.9p**	0.5p
Share of shared assets	**0.5p**	0.2p
Adjusted (loss)/earnings per share	**(5.2p)**	44.5p

Analysis of income, expenses and impairment losses – pro forma

	2008 £m	2007 £m
Fees and commissions receivable	**8,839**	9,171
Fees and commissions payable		
- banking	**(1,990)**	(1,681)
- insurance related	**(401)**	(466)
Net fees and commissions	**6,448**	7,024
Foreign exchange	**1,940**	1,389
Interest rate	**1,266**	2,230
Credit	**(5,121)**	295
Other	**268**	894
Income from trading activities	**(1,647)**	4,808
Operating lease and other rental income	**1,469**	1,671
Changes in the fair value of securities and other financial assets and liabilities	**(1,321)**	30
Changes in the fair value of investment properties	**(86)**	288
Profit on sale of securities	**113**	502
Profit on sale of property, plant and equipment	**177**	439
Profit on sale of subsidiaries and associates	**501**	67
Life company (losses)/profits	**(52)**	187
Dividend income	**274**	127
Share of profits less losses of associated entities	**10**	66
Other income	**(659)**	(9)
Other operating income	**426**	3,368
Non-interest income (excluding insurance premiums)	**5,227**	15,200
Insurance net premium income	**5,709**	5,982
Total non-interest income	**10,936**	21,182
Staff costs		
- wages, salaries and other staff costs	**6,711**	8,139
- social security costs	**526**	532
- pension costs	**489**	674
Premises and equipment	**2,084**	1,809
Other	**4,315**	3,767
Administrative expenses	**14,125**	14,921
Depreciation and amortisation	**1,791**	1,697
Operating expenses	**15,916**	16,618
General insurance	**3,733**	4,010
Bancassurance	**184**	518
Insurance net claims	**3,917**	4,528
Loan impairment losses	**6,478**	2,082
Impairment of available-for-sale securities	**484**	22
Impairment losses	**6,962**	2,104

Note: the data above exclude credit market write-downs and one-off items, amortisation of purchased intangibles, write-down of goodwill and other intangible assets, integration costs, restructuring costs and share of Consortium shared assets.

Asset quality – pro forma

Analysis of loans and advances to customers – pro forma

The following table analyses loans and advances to customers (excluding reverse repurchase agreements and stock borrowing) by industry and geography.

	2008 £m	2007 £m
UK Domestic		
Central and local government	**3,091**	3,135
Finance	**28,013**	15,056
Individuals – home	**80,967**	73,834
Individuals – other	**26,979**	28,123
Other commercial and industrial comprising:		
- Manufacturing	**15,067**	13,452
- Construction	**10,171**	10,202
- Service industries and business activities	**58,552**	53,965
- Agriculture, forestry and fishing	**2,972**	2,473
- Property	**52,087**	50,051
Finance leases and instalment credit	**17,363**	15,632
Interest accruals	**1,687**	1,634
	296,949	267,557
UK International		
Central and local government	**3,015**	1,593
Finance	**35,009**	21,200
Individuals – other	**490**	561
Other commercial and industrial comprising:		
- Manufacturing	**10,932**	7,631
- Construction	**3,255**	2,161
- Service industries and business activities	**29,782**	20,434
- Agriculture, forestry and fishing	**146**	97
- Property	**21,923**	13,664
Interest accruals	**37**	79
	104,589	67,420
Overseas		
Europe		
Central and local government	**1,830**	1,560
Finance	**9,631**	16,385
Individuals – home	**23,394**	16,435
Individuals – other	**4,641**	6,522
Other commercial and industrial comprising:		
- Manufacturing	**25,842**	11,522
- Construction	**5,183**	3,864
- Service industries and business activities	**40,444**	30,431
- Agriculture, forestry and fishing	**1,327**	1,843
- Property	**19,769**	13,281
Finance leases and instalment credit	**1,815**	1,620
Interest accruals	**798**	267
	134,674	103,730

Asset Quality – pro forma (continued)

	2008	2007
	£m	£m
US		
Central and local government	**482**	386
Finance	**16,088**	14,534
Individuals – home	**34,235**	27,882
Individuals – other	**14,368**	10,879
Other commercial and industrial comprising:		
- Manufacturing	**13,127**	7,311
- Construction	**885**	793
- Service industries and business activities	**27,913**	16,460
- Agriculture, forestry and fishing	**30**	20
- Property	**6,579**	6,456
Finance leases and instalment credit	**3,066**	2,228
Interest accruals	**471**	409
	117,244	87,358
Rest of World		
Central and local government	**7,079**	2,270
Finance	**11,722**	12,431
Individuals – home	**795**	1,073
Individuals – other	**4,592**	3,326
Other commercial and industrial comprising:		
- Manufacturing	**6,196**	5,057
- Construction	**756**	716
- Service industries and business activities	**13,152**	9,237
- Agriculture, forestry and fishing	**153**	308
- Property	**2,918**	2,455
Finance leases and instalment credit	**111**	18
Interest accruals	**270**	72
	47,744	36,963
Loans and advances to customers – gross	**701,200**	563,028
Loan impairment provisions	**(9,324)**	(4,953)
Total loans and advances to customers	**691,876**	558,075

Risk elements in lending – pro forma

The Group's loan control and review procedures do not include the classification of loans as non-accrual, accruing past due, restructured and potential problem loans, as defined by the Securities and Exchange Commission ('SEC') in the US. The following table shows the estimated amount of loans which would be reported using the SEC's classifications. The figures are stated before deducting the value of security held or related provisions.

	2008	2007
	£m	£m
Loans accounted for on a non-accrual basis (2):		
- Domestic	**8,579**	5,599
- Foreign	**8,503**	2,350
	17,082	7,949
Accruing loans which are contractually overdue 90 days or more as to principal or interest (3):		
- Domestic	**1,201**	217
- Foreign	**508**	85
	1,709	302
Total risk elements in lending	**18,791**	8,251
Potential problem loans (4):		
- Domestic	**218**	63
- Foreign	**8**	68
	226	131
Closing provisions for impairment as a % of total risk elements in lending and potential problem loans	**50%**	59%
Risk elements in lending as a % of gross lending to customers excluding reverse repos	**2.66%**	1.46%
Risk elements in lending and potential problem loans as a % of gross lending to customers excluding reverse repos	**2.69%**	1.49%

Notes:

(1) For the analysis above, 'Domestic' consists of the United Kingdom domestic transactions of the Group. 'Foreign' comprises the Group's transactions conducted through offices outside the UK and through those offices in the UK specifically organised to service international banking transactions.

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

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

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

Regulatory ratios – proportional consolidated basis

	Basel II 31 December 2008 £m	As published Basel II 1 January 2008 £m	Basel I 31 December 2007 £m
Capital base			
Core Tier 1 capital: ordinary shareholders' funds and minority interests less intangibles	**35,473**	19,596	19,596
Preference shares and tax deductible securities	**23,091**	14,704	14,704
Deductions from Tier 1 capital net of tax credit on expected losses	**(1,440)**	(1,187)	n/a
Tier 1 capital	**57,124**	33,113	34,300
Tier 2 capital	**28,967**	24,594	29,250
Tier 3 capital	**260**	200	200
	86,351	57,907	63,750
Less: Supervisory deductions	**(4,155)**	(5,078)	(8,202)
Total regulatory capital	**82,196**	52,829	55,548
Risk-weighted assets			
Credit risk	**433,400**	394,700	
Counterparty risk	**61,100**	37,500	
Market risk	**46,500**	17,900	
Operational risk	**36,800**	36,000	
	577,800	486,100	
Banking book			445,800
Trading book			44,200
			490,000
Risk asset ratio			
Core Tier 1	**6.1%**	4.0%	4.0%
Tier 1	**9.9%**	6.8%	7.0%
Total	**14.2%**	10.9%	11.3%

On 19 January 2009 the Group announced a capital restructuring. HM Treasury will fully underwrite an open offer to raise £5 billion through an issue of new ordinary shares, the proceeds from which will be used to redeem the £5 billion preference shares it holds. Had the capital restructuring taken place on 31 December 2008 the Core Tier 1 ratio would have been 7.0%; the Tier 1 ratio would be unchanged.

In computing its capital ratios, the Group reduces Tier 1 capital by the amount of the regulatory deductions net of tax credit on the excess of expected losses over provisions. If this deduction is taken from Core Tier 1 capital instead, the Core Tier 1 ratio would be 25 basis points lower. The Tier 1 capital ratio would be unchanged.

Regulatory ratios – proportional consolidated basis (continued)

	Basel II 31 December 2008 £m	As published Basel II 1 January 2008 £m	As published Basel I 31 December 2007 £m
Composition of regulatory capital			
Tier 1			
Ordinary shareholders' equity	**45,525**	44,684	44,684
Minority interests	**5,436**	5,391	5,391
Adjustments for:			
Goodwill and other intangible assets	**(16,386)**	(26,811)	(26,811)
Unrealised losses on available-for-sale debt securities	**3,687**	630	630
Reserves arising on revaluation of property and unrealised gains on available-for-sale equities	**(984)**	(3,321)	(3,321)
Reallocation of preference shares and innovative securities	**(1,813)**	(1,813)	(1,813)
Other regulatory adjustments	**8**	836	836
Core Tier 1 capital	**35,473**	19,596	19,596
Preference shares	**16,655**	9,559	9,559
Innovative Tier 1 securities	**6,436**	5,145	5,145
Tax on the excess of expected losses over provisions	**615**	1,173	n/a
Less deductions from Tier 1 capital	**(2,055)**	(2,360)	n/a
Total Tier 1 capital	**57,124**	33,113	34,300
Tier 2			
Reserves arising on revaluation of property and unrealised gains on available-for-sale equities	**984**	3,321	3,321
Collective impairment allowances	**666**	286	2,582
Perpetual subordinated debt	**9,079**	9,328	9,328
Term subordinated debt	**20,282**	13,910	13,910
Minority and other interests in Tier 2 capital	**11**	109	109
Less deductions from Tier 2 capital	**(2,055)**	(2,360)	n/a
Total Tier 2 capital	**28,967**	24,594	29,250
Tier 3	**260**	200	200
Supervisory deductions			
Unconsolidated investments	**4,044**	4,248	4,297
Other deductions	**111**	830	3,905
Total deductions other than from Tier 1 capital	**4,155**	5,078	8,202
Total regulatory capital	**82,196**	52,829	55,548

Derivatives – pro forma

As at 31 December 2008	Assets £m	Liabilities £m
Exchange rate contracts		
Spot, forwards and futures	**82,963**	**83,433**
Currency swaps	**53,231**	**54,413**
Options purchased	**36,688**	**-**
Options written	**-**	**34,946**
Interest rate contracts		
Interest rate swaps	**547,564**	**530,830**
Options purchased	**99,176**	**-**
Options written	**-**	**102,210**
Futures and forwards	**7,600**	**6,620**
Credit derivatives	**142,367**	**132,734**
Equity and commodity contracts	**21,904**	**24,210**
	991,493	**969,396**

Certain derivative asset and derivative liability balances with the London Clearing House, which meet the offset criteria in IAS 32 'Financial Instruments: Presentation', are now shown net. Amounts for 2007 have been restated reducing derivative assets and derivative liabilities by £60,008 million.

The Group enters into master netting agreements in respect of its derivatives activities. These arrangements, which give the Group a legal right to set-off derivative assets and liabilities with the same counterparty, do not result in a net presentation in the Group's balance sheet for which IFRS requires an intention to settle net or to realise the asset and settle the liability simultaneously as well as a legally enforceable right to set off. They are however effective in reducing the Group's credit exposure from derivative assets. The Group has executed master netting agreements with the majority of its derivative counterparties resulting in a significant reduction in its net exposure to derivative assets. The extent of netting under such agreements amounted to £834 billion at 31 December 2008. Furthermore, the Group holds substantial collateral against this net derivative asset exposure.

Market risk – pro forma

The Group manages the market risk in its trading and treasury portfolios through its market risk management framework. This expresses limits based on, but not limited to: value-at-risk (VaR); stress testing and scenario analysis; and position and sensitivity analyses. VaR is a technique that produces estimates of the potential negative change in the market value of a portfolio over a specified time horizon at given confidence levels. The table below sets out the VaR, at a 95% confidence level and a one-day time horizon, for the Group's trading and treasury portfolios. The VaR for the Group's trading portfolios includes idiosyncratic risk and is segregated by type of market risk exposure.

	Average £m	Period end £m	Maximum £m	Minimum £m
Trading VaR				
Interest rate	**20.7**	**26.3**	**36.5**	**12.1**
Credit spread	**37.2**	**40.4**	**51.2**	**26.0**
Currency	**4.5**	**8.7**	**10.5**	**1.2**
Equity	**12.3**	**9.4**	**19.9**	**6.0**
Commodity	**6.7**	**6.3**	**18.2**	**-**
Diversification effects		**(43.3)**		
2008	**44.6**	**47.8**	**60.9**	**29.9**
2007	21.6*	45.7	50.1*	13.2*
Treasury VaR				
2008	**8.3**	**52.0**	**52.0**	**4.8**
2007	3.7*	5.5	6.4*	1.3*

* ABN AMRO positions prior to its acquisition by the Group are not included.

The Group's VaR should be interpreted in light of the limitations of the methodologies used. These limitations include:

- Historical data may not provide the best estimate of the joint distribution of risk factor changes in the future and may fail to capture the risk of possible extreme adverse market movements which have not occurred in the historical window used in the calculations.
- VaR using a one-day time horizon does not fully capture the market risk of positions that cannot be liquidated or hedged within one day.
- VaR using a 95% confidence level does not reflect the extent of potential losses beyond that percentile.

The Group largely computes the VaR of trading portfolios at the close of business and positions may change substantially during the course of the trading day. Controls are in place to limit the Group's intra-day exposure, such as the calculation of VaR for selected portfolios. These limitations and the nature of the VaR measure mean that the Group cannot guarantee that losses will not exceed the VaR amounts indicated. The Group undertakes stress testing to identify the potential for losses in excess of the VaR.

The Group's treasury activities include its money market business and the management of internal funds flow within the Group's businesses.

Statutory results

The condensed consolidated income statement, condensed consolidated balance sheet, condensed consolidated statement of recognised income and expense, condensed consolidated cash flow statement and related notes presented on pages 66 to 84 inclusive are on a statutory basis and include the results of ABN AMRO. The interests of the State of the Netherlands and Santander in RFS Holdings are included in minority interests.

Condensed consolidated income statement
for the year ended 31 December 2008

In the income statement below, credit market write-downs and one-off items, amortisation of purchased intangible assets and integration costs are included in non-interest income and operating expenses, as appropriate.

	2008	2007
	£m	£m
Interest receivable	**49,522**	32,252
Interest payable	**30,847**	20,183
Net interest income	**18,675**	12,069
Fees and commissions receivable	**9,831**	8,278
Fees and commissions payable	**(2,386)**	(2,193)
(Loss)/income from trading activities	**(8,477)**	1,292
Other operating income (excluding insurance premium income)	**1,899**	4,833
Net insurance premium income	**6,326**	6,087
Non-interest income	**7,193**	18,297
Total income	**25,868**	30,366
Staff costs	**10,241**	7,338
Premises and equipment	**2,593**	1,703
Other administrative expenses	**5,464**	2,969
Depreciation and amortisation	**3,154**	1,932
Write-down of goodwill and other intangible assets	**32,581**	-
Operating expenses*	**54,033**	13,942
(Loss)/profit before other operating charges and impairment	**(28,165)**	16,424
Net insurance claims	**4,430**	4,624
Impairment	**8,072**	1,968
Operating (loss)/profit before tax	**(40,667)**	9,832
Tax (credit)/charge	**(2,323)**	2,044
(Loss)/profit from continuing operations	**(38,344)**	7,788
Profit/(loss) from discontinued operations, net of tax	**3,971**	(76)
(Loss)/profit for the period	**(34,373)**	7,712
Minority interests	**(10,832)**	163
Other owners' dividends	**596**	246
(Loss)/profit attributable to ordinary shareholders	**(24,137)**	7,303
Basic earnings per ordinary share (Note 6)	**(145.7p)**	64.0p
Diluted earnings per ordinary share (Note 6)	**(145.7p)**	63.4p

*Operating expenses include:	**£m**	£m
Integration and restructuring costs:		
- Administrative expenses	**1,321**	48
- Depreciation and amortisation	**36**	60
	1,357	108
Amortisation of purchased intangible assets	**443**	262
	1,800	370

Loss
Loss before tax was £40,667 million compared with a profit of £9,832 million in 2007. The results have been adversely affected by credit market write-downs of £7,781 million and write-down of goodwill and other intangible assets of £32,581 million.

Total income
Total income was down 15% to £25,868 million, principally due to the credit market write-downs.

Net interest income increased to £18,675 million and represents 72% of total income (2007 – 40%).

Non-interest income decreased to £7,193 million principally due to the credit market write-downs of £7,781 million offset by a movement in the fair value of own debt of £1,232 million, and represents 28% of total income (2007 – 60%).

Operating expenses
Operating expenses rose to £54,033 million. Integration and restructuring costs were £1,357 million compared with £108 million in 2007. Write-down of goodwill and other intangible assets was £32,581 million.

Net insurance claims
Bancassurance and general insurance claims, after reinsurance, decreased by 4% to £4,430 million.

Impairment losses
Impairment losses were £8,072 million, compared with £1,968 million in 2007.

Risk elements in lending and potential problem loans represented 2.52% of gross loans and advances to customers excluding reverse repos at 31 December 2008 (2007 – 1.64%).

Provision coverage of risk elements in lending and potential problem loans was 51% (2007 – 57%).

Taxation
The effective tax rate for 2008 was 5.7% compared with 20.8% in 2007.

Earnings
Basic earnings per ordinary share decreased from 64.0p to a loss of 145.7p

Capital
Capital ratios at 31 December 2008 were 6.8% (Core Tier 1), 10.0% (Tier 1) and 14.1% (Total).

Rights issue
In June 2008, the company completed the £12 billion rights issue announced in April 2008. As a result, on 9 June 2008, the company issued 6.1 billion new ordinary shares of 25p each.

Capitalisation issue
As announced in April 2008, the company issued new ordinary shares of 25p each in the company instead of paying an interim dividend in cash.

Placing and open offer
In December 2008, the company completed the placing and open offer announced in October 2008. As a result, the company issued 22.9 billion new ordinary shares of 25p each, the net proceeds being £14.7 billion.

Condensed consolidated balance sheet
at 31 December 2008

	2008 £m	2007 £m
Assets		
Cash and balances at central banks	**12,400**	17,866
Net loans and advances to banks	**79,426**	43,519
Reverse repurchase agreements	**58,771**	175,941
Loans and advances to banks	**138,197**	219,460
Net loans and advances to customers	**835,409**	686,181
Reverse repurchase agreements and stock borrowing	**39,313**	142,357
Loans and advances to customers	**874,722**	828,538
Debt securities	**267,549**	294,656
Equity shares	**26,330**	53,026
Settlement balances	**17,832**	16,589
Derivatives	**992,559**	277,402
Intangible assets	**20,049**	49,916
Property, plant and equipment	**18,949**	18,745
Deferred taxation	**7,082**	3,119
Prepayments, accrued income and other assets	**24,402**	15,662
Assets of disposal groups	**1,581**	45,850
Total assets	**2,401,652**	1,840,829
Liabilities		
Deposits by banks	**174,378**	149,256
Repurchase agreements and stock lending	**83,666**	163,038
Deposits by banks	**258,044**	312,294
Customer accounts	**581,369**	547,447
Repurchase agreements and stock lending	**58,143**	134,916
Customer accounts	**639,512**	682,363
Debt securities in issue	**300,289**	274,172
Settlement balances and short positions	**54,277**	91,021
Derivatives	**971,364**	272,052
Accruals, deferred income and other liabilities	**31,482**	34,208
Retirement benefit liabilities	**2,032**	460
Deferred taxation	**4,165**	5,400
Insurance liabilities	**9,976**	10,162
Subordinated liabilities	**49,154**	38,043
Liabilities of disposal groups	**859**	29,228
Total liabilities	**2,321,154**	1,749,403
Equity:		
Minority interests	**21,619**	38,388
Owners' equity*		
Called up share capital	**9,898**	2,530
Reserves	**48,981**	50,508
Total equity	**80,498**	91,426
Total liabilities and equity	**2,401,652**	1,840,829

***Owners' equity attributable to:**		
Ordinary shareholders	**45,525**	44,684
Other equity owners	**13,354**	8,354
	58,879	53,038

Overview of condensed consolidated balance sheet

Total assets of £2,401.7 billion at 31 December 2008 were up £560.8 billion, 30%, compared with 31 December 2007.

Loans and advances to banks decreased by £81.3 billion, 37%, to £138.2 billion. Reverse repurchase agreements and stock borrowing ("reverse repos") were down by £117.2 billion, 67% to £58.8 billion. Excluding reverse repos, bank placings increased by £35.9 billion, 83%, to £79.4 billion.

Loans and advances to customers were up £46.2 billion, 6%, at £874.7 billion or £68.0 billion, 8% following the disposal of the Banco Real and other businesses to Santander and Tesco Personal Finance. Within this, reverse repos decreased by 72%, £103.0 billion to £39.3 billion. Excluding reverse repos, lending rose by £149.2 billion, 22% to £835.4 billion reflecting both organic growth and the effect of exchange rate movements following the weakening of sterling during the second half of 2008.

Debt securities decreased by £27.1 billion, 9%, to £267.5 billion and equity shares decreased by £26.7 billion, 50%, to £26.3 billion principally due to lower holdings in Global Banking & Markets.

Movements in the value of derivatives, assets and liabilities, primarily reflect changes in interest and exchange rates, together with growth in trading volumes.

Intangible assets declined by £29.9 billion, 60% to £20.0 billion, reflecting impairment of £32.6 billion and the disposals of the Asset Management business of ABN AMRO, Banca Antonveneta and the Banco Real and other businesses of ABN AMRO acquired by Santander, £7.2 billion. This was offset by exchange rate movements of £11.8 billion goodwill of £0.2 billion arising on the Sempra joint venture and £0.3 billion on the buyout of the outstanding ABN AMRO shareholdings not previously owned by the Group.

Deferred tax assets increased £4.0 billion to £7.1 billion principally due to carried forward trading losses.

Prepayments, accrued income and other assets were up £8.7 billion, 56% to £24.4 billion.

Assets and liabilities of disposal groups decreased following completion of the sales of the Asset Management business of ABN AMRO to Fortis, Banca Antonveneta to Monte dei Paschi di Sienna and the majority of ABN AMRO's Private Equity business to third parties.

Deposits by banks declined by £54.3 billion, 17% to £258.0 billion. This reflected decreased repurchase agreements and stock lending ("repos"), down £79.4 billion, 49% to £83.7 billion partly offset by increased inter-bank deposits, up £25.1 billion, 17% to £174.4 billion.

Customer accounts were down £42.9 billion, 6% to £639.5 billion or £21.6 billion, 3% excluding disposals of subsidiaries. Within this, repos decreased £76.8 billion, 57% to £58.1 billion. Excluding repos, deposits rose by £33.9 billion, 6%, to £581.4 billion.

Debt securities in issue were up £26.1 billion, 10% to £300.3 billion mainly resulting from the effect of exchange rate movements.

Settlement balances and short positions were down £36.7 billion, 40%, to £54.3 billion reflecting reduced customer activity.

Accruals, deferred income and other liabilities decreased £2.7 billion, 8%, to £31.5 billion primarily as a result of disposals.

Retirement benefit liabilities increased by £1.6 billion to £2.0 billion due to reduced asset values only partly offset by the effect of increased discount rates.

Deferred taxation liabilities decreased by £1.2 billion, 23% to £4.2 billion due in part to the sale of Angel Trains.

Subordinated liabilities were up £11.1 billion, 29% to £49.2 billion. The issue of £2.4 billion dated loan capital and the effect of exchange rate and other adjustments, £11.3 billion, were partially offset by the redemption of £1.6 billion of dated loan capital, £0.1 billion undated loan capital and £0.9 billion in respect of the disposal of the Banco Real and other businesses of ABN AMRO to Santander.

Equity minority interests decreased by £16.8 billion, 44% to £21.6 billion. Attributable losses of £10.8 billion, including £15.7 billion of write downs of goodwill and other intangible assets in respect of the State of the Netherlands investment in RFS Holdings, equity withdrawals of £13.6 billion, including £12.3 billion by Santander following the disposals of Banca Antonveneta and Banco Real, reductions in the market value of available-for-sale securities of £1.4 billion, mainly the investment in Bank of China attributable to minority shareholders, movements in cash flow hedging reserves, £0.8 billion, actuarial losses on defined benefit pension schemes net of tax of £0.5 billion and dividends paid of £0.3 billion, were partially offset by effect of exchange rate movements of £9.1 billion of which £8.0 billion related to the State of the Netherlands and Santander investments in RFS Holdings, the £0.8 billion equity raised as part of the Sempra joint venture and £0.4 billion additional equity in respect of the buy-out of the ABN AMRO minority shareholders.

Owners' equity increased by £5.8 billion, 11% to £58.9 billion. Proceeds of £12.0 billion from the rights issue, net of £246 million expenses, and £19.7 billion from the placing and open offer, net of expenses of £265 million, together with exchange rate movements of £6.8 billion were partially offset by the attributable loss for the period of £23.5 billion, a £4.6 billion decrease in available-for-sale reserves, net of tax, reflecting £1.0 billion in the Group’s share in the investment in Bank of China and £3.6 billion in other securities, the majority of which related to Global Banking & Markets, actuarial losses net of tax of £1.3 billion, the payment of the 2007 final ordinary dividend of £2.3 billion and other dividends of £0.6 billion, and a reduction in the cash flow hedging reserve of £0.3 billion.

Condensed consolidated statement of recognised income and expense for the year ended 31 December 2008

	2008 £m	2007 £m
Net movements in reserves:		
Available-for-sale	**(7,406)**	(1,289)
Cash flow hedges	**(1,456)**	(564)
Currency translation	**15,425**	2,210
Actuarial gains on defined benefit plans	**(2,287)**	2,189
Tax on items recognised direct in equity	**2,786**	(170)
Net income recognised direct in equity	**7,062**	2,376
(Loss)/profit for the period	**(34,373)**	7,712
Total recognised income and expense for the period	**(27,311)**	10,088
Attributable to:		
Equity shareholders	**(22,979)**	8,610
Minority interests	**(4,332)**	1,478
	(27,311)	10,088

Condensed consolidated cash flow statement
for the year ended 31 December 2008

	2008 £m	2007 £m
Operating activities		
Operating (loss)/profit before tax	**(40,667)**	9,832
Operating profit before tax on discontinued activities	**4,208**	68
Adjustments for:		
Depreciation and amortisation	**3,154**	1,932
Write-down of goodwill and intangibles	**32,581**	-
Interest on subordinated liabilities	**2,144**	1,518
Charge for defined benefit pension schemes	**490**	489
Cash contribution to defined benefit pension schemes	**(810)**	(599)
Elimination of non-cash items on discontinued activities	**592**	62
Elimination of foreign exchange differences	**(41,874)**	(10,282)
Other non-cash items	**8,603**	(3,235)
Net cash inflow from trading activities	**(31,579)**	(215)
Changes in operating assets and liabilities	**(42,219)**	28,261
Net cash flows from operating activities before tax	**(73,798)**	28,046
Income taxes paid	**(1,540)**	(2,442)
Net cash flows from operating activities	**(75,338)**	25,604
Investing activities		
Sale and maturity of securities	**53,390**	63,007
Purchase of securities	**(55,229)**	(61,020)
Sale of property, plant and equipment	**2,228**	5,786
Purchase of property, plant and equipment	**(5,757)**	(5,080)
Net investment in business interests and intangible assets	**2,252**	13,640
Proceeds on disposal of discontinued activities	**20,113**	(334)
Net cash flows from investing activities	**16,997**	15,999
Financing activities		
Issue of ordinary shares	**49**	77
Issue of other equity interests	**-**	3,600
Issue of paid up equity	**-**	1,073
Placing and open offer	**19,741**	-
Rights issue	**12,000**	-
Issue of subordinated liabilities	**2,413**	1,018
Proceeds of minority interests issued	**1,427**	31,095
Redemption of minority interests	**(13,579)**	(545)
Shares purchased by employee trusts	**(64)**	(65)
Shares issued under employee share schemes	**2**	79
Repayment of subordinated liabilities	**(1,727)**	(1,708)
Dividends paid	**(3,193)**	(3,411)
Interest paid on subordinated liabilities	**(1,967)**	(1,522)
Net cash flows from financing activities	**15,102**	29,691
Effects of exchange rate changes on cash and cash equivalents	**29,209**	6,010
Net increase in cash and cash equivalents	**(14,030)**	77,304
Cash and cash equivalents at beginning of period	148,955	71,651
Cash and cash equivalents at end of period	**134,925**	148,955

1. Basis of preparation

The accounts for the year ended 31 December 2008 have been prepared on a going concern basis. The directors have reviewed the Group's forecasts, projections and other relevant evidence including the ongoing measures from governments and central banks in the UK and around the world to sustain the banking sector. Whilst the Group has received no guarantees, the directors have a reasonable expectation, based on experience to date, of continued and sufficient access to these funding facilities and, accordingly, that the Group will continue in operational existence for the foreseeable future.

2. Accounting policies

The annual accounts of the Group are prepared in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board ("IASB") and interpretations issued by the International Financial Reporting Interpretations Committee of the IASB (together "IFRS") as adopted by the European Union ("EU"). It also complies with IFRS as issued by the IASB. There have been no significant changes to the Group's principal accounting policies. The Group adopted IFRS 8 'Operating Segments' with effect from 1 January 2008. The Group also adopted the amendments to IAS 39 'Financial Instruments: Recognition and Measurement', announced in October 2008, with effect from 1 July 2008.

3. Restatements

The income statement and related notes and the cash flow statement for the year ended 31 December 2007 have been restated to reflect the reclassification of Banco Real as a discontinued operation. The balance sheet as at 31 December 2007 has been restated for the finalisation of the purchase accounting adjustments in respect of ABN AMRO and the netting of certain derivative contracts.

4. Loan impairment provisions

Operating (loss)/profit is stated after charging loan impairment losses of £7,091 million (2007 - £1,946 million). The balance sheet loan impairment provisions increased in the year ended 31 December 2008 from £6,452 million to £11,016 million, and the movements thereon were:

	2008 **£m**	2007 £m
At beginning of year	**6,452**	3,935
Transfer to disposal groups	**(767)**	-
Currency translation and other adjustments	**1,441**	137
Acquisition of subsidiaries	**-**	2,221
Disposals	**(178)**	-
Net increase in provisions of discontinued operations	**-**	46
Amounts written-off	**(3,148)**	(2,011)
Recoveries of amounts previously written-off	**319**	342
Charge to the income statement	**7,091**	1,946
Unwind of discount	**(194)**	(164)
At end of year	**11,016**	6,452

The provision at 31 December 2008 includes £127 million (2007 - £3 million) in respect of loans and advances to banks.

5. Taxation

The charge for taxation on continuing operations comprises:

	2008 £m	2007 £m
Tax (credit)/charge	**(2,323)**	2,044
Overseas tax included above	**133**	500

The credit for taxation represents 5.7% (2007 – 20.8% charge) of (loss)/profit before tax. It differs from the tax charge computed by applying the standard UK corporation tax rate of 28.5% as follows:

	2008 £m	2007 £m
(Loss)/profit before tax	**(40,667)**	9,832
Expected tax (credit)/charge at 28.5% (2007 – 30%)	**(11,590)**	2,950
Non-deductible goodwill impairment	**8,292**	12
Unrecognised timing differences	**274**	29
Other non-deductible items	**330**	222
Non-taxable items	**(491)**	(595)
Foreign profits taxed at other rates	**203**	(25)
Reduction in deferred tax liability following change in the rate of UK Corporation Tax	**-**	(189)
Losses in year not recognised	**942**	2
Other	**69**	5
Adjustments in respect of prior periods	**(352)**	(367)
Actual tax (credit)/charge	**(2,323)**	2,044

6. Earnings per share

Earnings per share have been calculated based on the following:

	2008	2007
	£m	£m
Earnings		
(Loss)/profit attributable to ordinary shareholders	**(24,137)**	7,303
Add back finance cost on dilutive convertible securities	**-**	60
Diluted earnings attributable to ordinary shareholders	**(24,137)**	7,363
Weighted average number of ordinary shares (millions)*		
In issue during the year	**16,563**	11,413
Effect of dilutive share options and convertible securities	**-**	198
Diluted weighted average number of ordinary shares in issue during the year	**16,563**	11,611
Basic earnings per share*	**(145.7p)**	64.0p
Diluted earnings per share*	**(145.7p)**	63.4p

*prior period data have been adjusted retrospectively for the bonus element of the rights issue completed in June 2008 and the capitalisation issue in September 2008.

7. Segmental analysis

Total revenue	External £m	Inter segment £m	Total £m
2008			
Global Markets			
- Global Banking & Markets	**10,324**	**13,135**	**23,459**
- Global Transaction Services	**3,087**	**80**	**3,167**
Regional Markets			
- UK Retail & Commercial Banking	**18,690**	**3,718**	**22,408**
- US Retail & Commercial Banking	**5,031**	**-**	**5,031**
- Europe & Middle East Retail & Commercial Banking	**3,572**	**738**	**4,310**
- Asia Retail & Commercial Banking	**823**	**350**	**1,173**
RBS Insurance	**6,177**	**33**	**6,210**
Group Manufacturing	**37**	**-**	**37**
Central items	**1,700**	**13,405**	**15,105**
Share of shared assets	**257**	**-**	**257**
RFS Holdings minority interest	**9,703**	**(24)**	**9,679**
Elimination of intra-group transactions	**-**	**(31,435)**	**(31,435)**
	59,401	**-**	**59,401**

7. Segmental analysis (continued)

2007	External £m	Inter segment £m	Total £m
Global Markets			
- Global Banking & Markets	13,338	9,544	22,882
- Global Transaction Services	2,959	77	3,036
Regional Markets			
- UK Retail & Commercial Banking	18,222	3,820	22,042
- US Retail & Commercial Banking	5,184	-	5,184
- Europe & Middle East Retail & Commercial Banking	2,940	197	3,137
- Asia Retail & Commercial Banking	563	330	893
RBS Insurance	6,333	89	6,422
Group Manufacturing	44	1	45
Central items	1,650	9,972	11,622
Share of shared assets	264	-	264
RFS Holdings minority interest	1,534	(255)	1,279
Elimination of intra-group transactions	-	(23,775)	(23,775)
	53,031	-	53,031

	2008 £m	2007 £m
Operating (loss)/profit before tax		
Global Markets		
- Global Banking & Markets	**(10,515)**	3,653
- Global Transaction Services	**1,818**	1,315
Total Global Markets	**(8,697)**	4,968
Regional Markets		
- UK Retail & Commercial Banking	**5,679**	6,225
- US Retail & Commercial Banking	**883**	1,479
- Europe & Middle East Retail & Commercial Banking	**429**	769
- Asia Retail & Commercial Banking	**127**	91
Total Regional Markets	**7,118**	8,564
RBS Insurance	**1,020**	905
Group Manufacturing	**(4,793)**	(3,773)
Central items	**(675)**	(552)
Share of shared assets	**(300)**	(73)
RFS Holdings minority interest	**(15,629)**	163
	(21,956)	10,202
Amortisation of purchased intangible assets	**(443)**	(262)
Integration and restructuring costs	**(1,357)**	(108)
Write-down of goodwill and other intangible assets	**(16,911)**	-
	(40,667)	9,832

7. Segmental analysis (continued)

	2008 £m	2007 £m
Total assets		
Global Markets		
- Global Banking & Markets	**1,672,158**	1,147,384
- Global Transaction Services	**23,962**	22,730
Total Global Markets	**1,696,120**	1,170,114
Regional Markets		
- UK Retail & Commercial Banking	**249,385**	232,821
- US Retail & Commercial Banking	**103,940**	79,078
- Europe & Middle East Retail & Commercial Banking	**66,382**	56,087
- Asia Retail & Commercial Banking	**8,284**	7,562
Total Regional Markets	**427,991**	375,548
RBS Insurance	**12,855**	12,459
Group Manufacturing	**6,105**	5,658
Central items	**73,575**	4,065
Share of shared assets	**2,047**	27,222
RFS Holdings minority interest	**182,959**	245,763
	2,401,652	1,840,829

8. Dividends and capitalisation issue

During the year a dividend of 23.1p per ordinary share (2007 – 22.1p) in respect of the final dividend for 2008 was paid to ordinary shareholders.

In September 2008, the company issued new ordinary shares to shareholders instead of paying the 2008 interim dividend in cash. Shareholders received a capitalisation issue of 1 new ordinary share for every 40 shares held resulting in an issue of 403 million new shares.

Currently, the company is unable to pay ordinary dividends as a result of the conditions attached to the issue of preference shares which formed part of the placing and open offer. This restriction will be removed when the preference shares are redeemed and replaced by the issue of ordinary shares, as announced on 19 January 2009. However, the directors do not intend to pay a dividend on ordinary shares during 2009.

9. Discontinued operations and assets and liabilities of disposal groups

Profit/(loss) from discontinued operations, net of tax

	2008	2007
	£m	£m
Discontinued operations:		
Total income	2,571	749
Operating expenses	(1,407)	(493)
Insurance net claims	-	(28)
Impairment losses	(564)	(160)
Profit before tax	600	68
Gain on disposal	3,859	-
Operating profit before tax	4,459	68
Tax on profit	(204)	(8)
Tax on gain on disposal	(33)	-
Profit after tax	4,222	60
Business acquired exclusively with a view to disposal:		
Loss after tax	(251)	(136)
Profit/(loss) from discontinued operations, net of tax	3,971	(76)

Discontinued operations reflect the results of Banco Real sold to Santander on 24 July 2008

Businesses acquired exclusively with a view to disposal comprise those ABN AMRO businesses, including Banca Antonveneta, Asset Management and Private Equity, classified as disposal groups on the acquisition of ABN AMRO on 17 October 2007. The Asset Management business was sold to Fortis on 3 April 2008. Banca Antonveneta, excluding its subsidiary Interbanca, was sold to Banca Monte dei Paschi de Siena S.p.A. on 30 May 2008

Assets and liabilities of disposal groups

	2008	2007
	£m	£m
Assets of disposal groups		
Property, plant and equipment	**66**	395
Assets acquired exclusively with a view to disposal	**1,515**	45,455
	1,581	45,850
Liabilities of disposal groups		
Liabilities acquired exclusively with a view to disposal	**859**	29,228

10. Retirement benefit liabilities

The Group's net pension deficit, measured in accordance with IAS 19, for all schemes was £1,996 million (2007: surplus £340 million). This was due to a decline in the value of plan assets which was partly offset by the effect on the valuation of liabilities of a higher discount rate reflecting an increase in AA+ long-term Corporate bond yields and reduction in the assumed rate of inflation.

11. Analysis of consolidated equity

	2008	2007
	£m	£m
Called-up share capital		
At beginning of year	**2,530**	815
Ordinary shares issued in respect of rights issue	**1,531**	-
Ordinary shares issued in respect of capitalisation issue	**101**	-
Ordinary shares issued in respect of placing and open offer	**5,728**	-
Preference shares issued in respect of placing and open offer	**5**	-
Other shares issued during the period	**3**	139
Bonus issue of ordinary shares	**-**	1,576
At end of year	**9,898**	2,530
Paid-in equity		
At beginning of year	**1,073**	-
Securities issued during the year	**-**	1,073
At end of year	**1,073**	1,073
Share premium account		
At beginning of year	**17,322**	12,482
Ordinary shares issued in respect of rights issue, net of £246 million expenses	**10,469**	-
Ordinary shares issued in respect of capitalisation issue	**(101)**	-
Expenses of placing and open offer	**(265)**	-
Other shares issued during the year	**46**	6,257
Bonus issue of ordinary shares	**-**	(1,576)
Redemption of preference shares classified as debt	**-**	159
At end of year	**27,471**	17,322
Merger reserve		
At beginning of year	**10,881**	10,881
Placing and open offer	**14,273**	-
Transfer to retained earnings	**(14,273)**	-
At end of year	**10,881**	10,881
Available-for-sale reserves (see note 12 below)		
At beginning of year	**1,032**	1,528
Unrealised losses in the year	**(6,808)**	(191)
Realised losses/(gains) in the year	**842**	(513)
Taxation	**1,373**	208
At end of year	**(3,561)**	1,032
Cash flow hedging reserve		
At beginning of year	**(555)**	(149)
Amount recognised in equity during the year	**(603)**	(460)
Amount transferred from equity to earnings in the year	**198**	(138)
Taxation	**84**	192
At end of year	**(876)**	(555)

11. Analysis of consolidated equity (continued)

	2008 £m	2007 £m
Foreign exchange reserve		
At beginning of year	**(426)**	(872)
Retranslation of net assets, net of related hedges	**11,970**	1,339
Foreign currency (losses)/gains on hedges of net assets	**(5,801)**	(963)
Taxation	**642**	70
At end of year	**6,385**	(426)
Capital redemption reserve		
At beginning and end of year	**170**	170
Retained earnings		
At beginning of year	**21,072**	15,487
(Loss)/profit attributable to ordinary shareholders and other equity owners.	**(23,541)**	7,549
Ordinary dividends paid	**(2,312)**	(3,044)
Equity preference dividends paid	**(536)**	(246)
Paid-in equity dividends paid, net of tax	**(60)**	-
Redemption of preference shares classified as debt	**-**	(159)
Transfer from merger reserve	**14,273**	-
Actuarial (losses)/gains recognised in retirement benefit schemes, net of tax	**(1,335)**	1,517
Net cost of shares bought and used to satisfy share-based payments	**(19)**	(40)
Share-based payments, net of tax	**-**	8
At end of year	**7,542**	21,072
Own shares held		
At beginning of year	**(61)**	(115)
Shares purchased during the year	**(64)**	(65)
Shares issued under employee share schemes	**21**	119
At end of year	**(104)**	(61)
Owners' equity at end of year	**58,879**	53,038
Minority interests		
At beginning of year	**38,388**	5,263
Currency translation adjustments and other movements	**9,256**	1,834
Acquisition of ABN AMRO	**356**	32,245
(Loss)/profit attributable to minority interests	**(10,832)**	163
Dividends paid	**(285)**	(121)
Losses on available-for-sale securities, net of tax	**(1,447)**	(564)
Movements in cash flow hedging reserves, net of tax	**(831)**	26
Actuarial losses recognised in retirement benefit schemes, net of tax	**(478)**	19
Equity raised	**1,071**	76
Equity withdrawn and disposals	**(13,579)**	(553)
At end of year	**21,619**	38,388

12. Available-for-sale reserves

Available-for-sale financial assets are initially recognised at fair value plus directly related transaction costs and subsequently measured at fair value with changes in fair value reported in shareholders' 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.

During 2008 impairment losses of £981 million (2007 £22 million) were charged to profit or loss and net unrealised losses of £6,808 million (2007 £191 million) were recognised directly in equity on available-for-sale financial assets. Available-for-sale reserves at 31 December 2008 amounted to net losses of £3,561 million (2007 net gains - £1,032 million).

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 and of securities issued by central and local governments other than the UK and the USA. The losses reflect the widening of credit spreads as a result of the reduced market liquidity in these securities and the current uncertain macro-economic outlook in US and Europe. The underlying securities remain unimpaired.

13. Analysis of contingent liabilities and commitments

	2008	2007
	£m	£m
Contingent liabilities		
Guarantees and assets pledged as collateral security	**49,262**	46,441
Other contingent liabilities	**22,275**	15,479
	71,537	61,920
Commitments		
Undrawn formal standby facilities, credit lines and other commitments to lend	**352,398**	332,811
Other commitments	**9,326**	5,368
	361,724	338,179
Total contingent liabilities and commitments	**433,261**	400,099

Additional contingent liabilities arise in the normal course of the Group's business. It is not anticipated that any material loss will arise from these transactions.

14. Litigation

United Kingdom

In common with other banks in the United Kingdom, RBS and NatWest have received claims and complaints from a large number of customers challenging unarranged overdraft charges (the 'Charges') as contravening the Unfair Terms in Consumer Contracts Regulations 1999 (the 'Regulations') or being unenforceable penalties (or both).

On 27 July 2007, the OFT issued proceedings in a test case against the banks which was intended to determine certain preliminary issues concerning the legal status and enforceability of contractual terms relating to the Charges. Because of the test case, most existing and new claims in the County Courts are currently stayed, the FSA temporarily waived the customer complaints-handling process and there is a standstill of Financial Ombudsman Service decisions.

A High Court judgment in April 2008 addressed preliminary issues in respect of the banks' contractual terms relating to the Charges in force in early 2008 (the 'Current Terms'). The judgment held that the Current Terms used by RBS and NatWest (i) are not unenforceable as penalties, but (ii) are not exempt from assessment for fairness under the Regulations.

RBSG (in common with the other banks) has accepted that the ruling in the April judgment that the Current Terms are not exempt from assessment for fairness applies also to a sample of the RBS and NatWest contractual terms relating to the Charges in force between 2001 and 2007 (the 'Historic Terms'). The High Court made an order to this effect in October 2008.

RBSG and the other banks have appealed against the rulings in April and October 2008 that the Current Terms and Historic Terms are not exempt from assessment for fairness under the Regulations. The hearing of the appeal in relation to Current Terms took place before the Court of Appeal in October and November 2008. The decision of the Court of Appeal is expected shortly. The appeal in relation to the Historic Terms is stayed pending the resolution of the appeal in relation to the Current Terms.

High Court judgments on further preliminary issues were handed down in October 2008 and January 2009. These judgments primarily addressed the question of whether certain Historic Terms were capable of being unenforceable penalties. The Judge decided that all of RBS's and most of NatWest's Historic Terms were not penalties, but that a term contained in a set of NatWest 2001 terms and conditions was a contractual prohibition against using a card to obtain an unarranged overdraft. The Judge did not decide whether any charge payable upon a breach of this prohibition was a penalty. RBSG has not appealed that decision.

The issues relating to the legal status and enforceability of the Charges are complex. RBSG maintains that its Charges are fair and enforceable and believes that it has a number of substantive and credible defences. RBSG cannot at this stage predict with any certainty the final outcome of the customer claims and complaints, the appeals referred to above and any further stages of the test case. It is unable reliably to estimate the liability, if any, that may arise as a result of or in connection with these matters or its effect on the Group's consolidated net assets, operating results or cash flows in any particular period.

14. Litigation (continued)

United States

Proceedings, including consolidated class actions on behalf of former Enron securities holders, have been brought in the United States against a large number of defendants, including the Group, following the collapse of Enron. The claims against the Group could be significant; the class plaintiff's position is that each defendant is responsible for an entire aggregate damage amount less settlements – they have not quantified claimed damages against the Group in particular. The Group considers that it has substantial and credible legal and factual defences to these claims and will continue to defend them vigorously. Recent decisions by the US Supreme Court and the US Federal Court for the Fifth Circuit provide further support for the Group's position. The 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.

RBS Group companies have been named as defendants in a number of purported class action and other lawsuits in the United States that relate to the sub-prime mortgage business. In general, the cases involve the issuance of sub-prime-related securities or the issuance of shares in companies with sub-prime-related exposure, where the plaintiffs have brought actions against the issuers and underwriters (including RBS Group companies) of such securities claiming that certain disclosures made in connection with the relevant offerings of such securities were false or misleading. The Group considers that it has substantial and credible legal and factual defences to these claims and will continue to defend them vigorously. The Group does not currently expect that these lawsuits, individually or in the aggregate, will have a material impact on its consolidated net assets, operating results or cash flows in any particular period.

The company and a number of its subsidiaries and certain individual officers and directors have been named as defendants in a number of class action complaints filed in the United States District Court for the Southern District of New York. The complaints allege that public filings in connection with the issuance of RBS Non-cumulative Dollar Preference Shares, ADS, including Series Q, Series R, Series S and Series T, contained false and misleading statements, and variously assert claims under Sections 11, 12 and 15 of the Securities Act 1933, Section 10 of the Securities Exchange Act of 1934 and SEC Rule 10b-5. Plaintiffs seek unquantified damages on behalf of purchasers of these shares. The proceedings are in their initial stages. The Group considers that it has substantial and credible legal and factual defences to these claims and will defend them vigorously. The 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.

Summary of other disputes, legal proceedings and litigation

Members of the 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. The Group has reviewed these other actual, threatened and known potential claims and proceedings and, after consulting with its legal advisers, does not expect that the outcome of these other claims and proceedings will have a material adverse effect on its consolidated net assets, operating results or cash flows in any particular period.

15. Regulatory enquiries and investigations

In the normal course of business the Group and its subsidiaries co-operate with regulatory authorities in various jurisdictions in their enquiries or investigations into alleged or possible breaches of regulations.

As previously disclosed by ABN AMRO, the United States Department of Justice has been conducting a criminal investigation into ABN AMRO's dollar clearing activities, Office of Foreign Assets Control compliance procedures and other Bank Secrecy Act compliance matters. ABN AMRO has cooperated and continues to cooperate fully with the investigation. Prior to the acquisition by the Group, ABN AMRO had reached an agreement in principle with the Department of Justice that would resolve all presently known aspects of the ongoing investigation by way of a Deferred Prosecution Agreement in return for a settlement payment by ABN AMRO of US$500 million (which amount was accrued by ABN AMRO in its interim financial statements for the six months ended 30 June 2007). Negotiations are continuing to enable a written agreement to be concluded.

Certain of the Group's subsidiaries have received requests for information from various US governmental agencies and self regulatory organisations 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 was advised by the SEC that it had commenced a non public, formal investigation relating to RBS's US sub-prime securities exposure and US residential mortgage exposures. The Group and its subsidiaries are cooperating with these various requests for information and investigations.

16. Related party transactions

Full details of the Group's related party transactions for the year ended 31 December 2008 will be included in the Group's 2008 Annual Report and Accounts.

17. Date of approval

This announcement was approved by the Board of directors on 25 February 2009.

18. Filings with the US Securities and Exchange Commission (SEC)

A report on Form 20-F will be filed with the Securities and Exchange Commission in the United States

Average balance sheet – statutory

	2008			2007		
	Average balance £m	**Interest £m**	**Rate %**	Average balance £m	Interest £m	Rate %
Assets						
Interest-earning assets – banking business	**887,194**	**49,938**	**5.63**	525,457	32,650	6.21
Trading business	**425,454**			313,110		
Non-interest-earning assets	**728,037**			284,405		
Total assets	**2,040,685**			1,122,972		
Liabilities						
Interest-bearing liabilities – banking business	**832,350**	**31,707**	**3.81**	474,691	20,719	4.36
Trading business	**466,610**			316,453		
Non-interest-bearing liabilities						
- demand deposits	**37,421**			32,871		
- other liabilities	**645,760**			255,598		
Shareholders' equity	**58,544**			43,359		
Total liabilities	**2,040,685**			1,122,972		

Average yields, spreads and margins of the banking business	**2008 %**	2007 %
Gross yield on interest-earning assets of banking business	**5.63**	6.21
Cost of interest-bearing liabilities of banking business	**(3.81)**	(4.36)
Interest spread of banking business	**1.82**	1.85
Benefit from interest-free funds	**0.23**	0.42
Net interest margin of banking business	**2.05**	2.27

Analysis of income, expense and impairment losses – statutory

	2008 £m	2007 £m
Fees and commissions receivable	**9,831**	8,278
Fees and commissions payable		
- banking	**(1,985)**	(1,727)
- insurance related	**(401)**	(466)
Net fees and commissions	**7,445**	6,085
Foreign exchange	**1,994**	1,085
Interest rate	**1,454**	1,414
Credit	**(12,200)**	(1,446)
Other	**275**	239
(Loss)/income from trading activities	**(8,477)**	1,292
Operating lease and other rental income	**1,525**	1,671
Changes in the fair value of own debt	**977**	152
Changes in the fair value of securities and other financial assets and liabilities	**(1,730)**	970
Changes in the fair value of investment properties	**(86)**	288
Profit on sale of securities	**342**	544
Profit on sale of property, plant and equipment	**167**	741
Profit on sale of subsidiaries and associates	**943**	67
Life company (losses)/profits	**(52)**	187
Dividend income	**281**	137
Share of profits less losses of associated entities	**69**	25
Other income	**(537)**	51
Other operating income	**1,899**	4,833
Non-interest income (excluding insurance premiums)	**867**	12,210
Insurance net premium income	**6,326**	6,087
Total non-interest income	**7,193**	18,297
Staff costs		
- wages, salaries and other staff costs	**8,907**	6,295
- social security costs	**696**	471
- pension costs	**638**	572
Premises and equipment	**2,593**	1,703
Other	**5,464**	2,969
Administrative expenses	**18,298**	12,010
Write-down of goodwill and other intangible assets	**32,581**	-
Depreciation and amortisation	**3,154**	1,932
Operating expenses	**54,033**	13,942
General insurance	**3,733**	4,010
Bancassurance	**697**	614
Insurance net claims	**4,430**	4,624
Loan impairment losses	**7,091**	1,946
Impairment of available-for-sale securities	**981**	22
Impairment losses	**8,072**	1,968

Asset quality – statutory

Analysis of loans and advances to customers – statutory

The following table analyses loans and advances to customers (excluding reverse repurchase agreements and stock borrowing) by industry and geography.

	2008 £m	2007 £m
UK Domestic		
Central and local government	**3,091**	3,135
Finance	**28,491**	14,847
Individuals – home	**80,967**	73,916
Individuals – other	**26,989**	28,186
Other commercial and industrial comprising:		
- Manufacturing	**15,074**	13,452
- Construction	**10,171**	10,202
- Service industries and business activities	**58,638**	53,966
- Agriculture, forestry and fishing	**2,972**	2,473
- Property	**52,127**	50,051
Finance leases and instalment credit	**17,363**	15,632
Interest accruals	**1,706**	2,115
	297,589	267,975
UK International		
Central and local government	**3,015**	1,593
Finance	**35,009**	21,200
Individuals – other	**490**	561
Other commercial and industrial comprising:		
- Manufacturing	**10,932**	7,631
- Construction	**3,255**	2,161
- Service industries and business activities	**29,782**	20,434
- Agriculture, forestry and fishing	**146**	97
- Property	**21,923**	13,664
Interest accruals	**37**	79
	104,589	67,420
Overseas		
Europe		
Central and local government	**2,045**	2,371
Finance	**19,408**	21,312
Individuals – home	**118,549**	81,557
Individuals – other	**9,024**	16,292
Other commercial and industrial comprising:		
- Manufacturing	**29,348**	15,159
- Construction	**5,838**	4,779
- Service industries and business activities	**60,179**	46,502
- Agriculture, forestry and fishing	**5,750**	4,650
- Property	**23,072**	15,768
Finance leases and instalment credit	**1,815**	1,620
Interest accruals	**1,490**	1,969
	276,518	211,979

Asset quality – statutory (continued)

	2008	2007
	£m	£m
US		
Central and local government	**482**	386
Finance	**16,088**	14,446
Individuals – home	**34,235**	27,882
Individuals – other	**14,368**	10,879
Other commercial and industrial comprising:		
- Manufacturing	**13,298**	7,399
- Construction	**885**	793
- Service industries and business activities	**28,233**	16,474
- Agriculture, forestry and fishing	**30**	20
- Property	**6,579**	6,456
Finance leases and instalment credit	**3,066**	2,228
Interest accruals	**471**	945
	117,735	87,908
Rest of World		
Central and local government	**7,079**	2,592
Finance	**12,038**	11,967
Individuals – home	**847**	1,740
Individuals – other	**5,089**	12,261
Other commercial and industrial comprising:		
- Manufacturing	**6,837**	8,078
- Construction	**758**	825
- Service industries and business activities	**13,706**	14,449
- Agriculture, forestry and fishing	**157**	1,941
- Property	**2,932**	2,898
Finance leases and instalment credit	**111**	18
Interest accruals	**313**	579
	49,867	57,348
Loans and advances to customers – gross	**846,298**	692,630
Loan impairment provisions	**(10,889)**	(6,449)
Total loans and advances to customers	**835,409**	686,181

Risk elements in lending – statutory

The Group's loan control and review procedures do not include the classification of loans as non-accrual, accruing past due, restructured and potential problem loans, as defined by the Securities and Exchange Commission ('SEC') in the US. The following table shows the estimated amount of loans which would be reported using the SEC's classifications. The figures are stated before deducting the value of security held or related provisions.

	2008	2007
	£m	£m
Loans accounted for on a non-accrual basis (2):		
- Domestic	**8,588**	5,599
- Foreign	**10,891**	4,763
	19,479	10,362
Accruing loans which are contractually overdue 90 days or more as to principal or interest (3):		
- Domestic	**1,201**	217
- Foreign	**581**	152
	1,782	369
Total risk elements in lending	**21,261**	10,731
Potential problem loans (4):		
- Domestic	**218**	63
- Foreign	**8**	608
	226	671
Closing provisions for impairment as a % of total risk elements in lending and potential problem loans	**51%**	57%
Risk elements in lending as a % of gross lending to customers excluding reverse repos	**2.50%**	1.54%
Risk elements in lending and potential problem loans as a % of gross lending to customers excluding reverse repos	**2.52%**	1.64%

(1) For the analysis above, 'Domestic' consists of the United Kingdom domestic transactions of the Group. 'Foreign' comprises the Group's transactions conducted through offices outside the UK and through those offices in the UK specifically organised to service international banking transactions.

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

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

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

Regulatory ratios – statutory

	Basel II 31 December 2008 £m	As published Basel II 1 January 2008 £m	As published Basel I 31 December 2007 £m
Capital base			
Core Tier 1 capital: ordinary shareholders' funds and minority interests less intangibles	**47,623**	27,324	27,324
Preference shares and tax deductible securities	**24,038**	17,040	17,040
Deductions from Tier 1 capital net of tax credit on expected losses	**(1,814)**	(1,457)	n/a
Tier 1 capital	**69,847**	42,907	44,364
Tier 2 capital	**32,223**	28,767	33,693
Tier 3 capital	**260**	200	200
	102,330	71,874	78,257
Less: Supervisory deductions	**(4,155)**	(5,078)	(10,283)
Total regulatory capital	**98,175**	66,796	67,974
Risk-weighted assets			
Credit risk	**551,400**	542,100	
Counterparty risk	**61,100**	37,500	
Market risk	**46,500**	17,900	
Operational risk	**36,800**	36,000	
	695,800	633,500	
Banking book			564,800
Trading book			44,200
			609,000
Risk asset ratio			
Core Tier 1	**6.8%**	4.3%	4.5%
Tier 1	**10.0%**	6.8%	7.3%
Total	**14.1%**	10.5%	11.2%

Regulatory ratios – statutory (continued)

		As published	
	Basel II	Basel II	Basel I
	31 December	1 January	31 December
	2008	2008	2007
	£m	£m	£m
Composition of regulatory capital			
Tier 1			
Ordinary shareholders' equity	**45,525**	44,684	44,684
Minority interests	**21,619**	38,388	38,388
Adjustments for:			
Goodwill and other intangible assets - continuing	**(20,049)**	(48,492)	(48,492)
Goodwill and other intangible assets - discontinued	**-**	(3,232)	(3,232)
Unrealised losses on available-for-sale debt securities	**3,687**	630	630
Reserves arising on revaluation of property and unrealised gains on available-for-sale equities	**(984)**	(3,321)	(3,321)
Reallocation of preference shares and innovative securities	**(1,813)**	(1,813)	(1,813)
Other regulatory adjustments	**(362)**	480	480
Core Tier 1 capital	**47,623**	27,324	27,324
Preference shares	**16,655**	10,560	10,560
Innovative Tier 1 securities	**7,383**	6,480	6,480
Tax on the excess of expected losses over provisions	**615**	1,173	n/a
Less deductions from Tier 1 capital	**(2,429)**	(2,630)	n/a
Total Tier 1 capital	**69,847**	42,907	44,364
Tier 2			
Reserves arising on revaluation of property and unrealised gains on available-for-sale equities	**984**	3,321	3,321
Collective impairment allowances	**666**	286	2,582
Perpetual subordinated debt	**9,829**	9,042	9,042
Term subordinated debt	**23,162**	18,639	18,639
Minority and other interests in Tier 2 capital	**11**	109	109
Less deductions from Tier 2 capital	**(2,429)**	(2,630)	n/a
Total Tier 2 capital	**32,223**	28,767	33,693
Tier 3	**260**	200	200
Supervisory deductions			
Unconsolidated investments	**4,044**	4,248	4,297
Other deductions	**111**	830	5,986
Total deductions other than from Tier 1 capital	**4,155**	5,078	10,283
Total regulatory capital	**98,175**	66,796	67,974

Derivatives - statutory

As at 31 December 2008	Assets £m	Liabilities £m
Exchange rate contracts		
Spot, forwards and futures	**83,065**	**83,568**
Currency swaps	**53,398**	**54,728**
Options purchased	**36,762**	**-**
Options written	**-**	**35,017**
Interest rate contracts		
Interest rate swaps	**548,040**	**532,180**
Options purchased	**99,192**	**-**
Options written	**-**	**102,216**
Futures and forwards	**7,600**	**6,620**
Credit derivatives	**142,366**	**132,734**
Equity and commodity contracts	**22,136**	**24,301**
	992,559	**971,364**

Certain derivative asset and derivative liability balances with the London Clearing House, which meet the offset criteria in IAS 32 'Financial Instruments: Presentation', are now shown net. Amounts for 2007 have been restated, reducing derivative assets and derivative liabilities by £60,008 million.

The Group enters into master netting agreements in respect of its derivatives activities. These arrangements, which give the Group a legal right to set-off derivative assets and liabilities with the same counterparty, do not result in a net presentation in the Group's balance sheet for which IFRS requires an intention to settle net or to realise the asset and settle the liability simultaneously as well as a legally enforceable right to set off. They are however effective in reducing the Group's credit exposure from derivative assets. The Group has executed master netting agreements with the majority of its derivative counterparties resulting in a significant reduction in its net exposure to derivative assets. The extent of netting under such agreements amounted to £834 billion at 31 December 2008. Furthermore the Group holds substantial collateral against this net derivative asset exposure.

Market risk – statutory

The Group manages the market risk in its trading and treasury portfolios through its market risk management framework. This expresses limits based on, but not limited to: value-at-risk (VaR); stress testing and scenario analysis; and position and sensitivity analyses. VaR is a technique that produces estimates of the potential negative change in the market value of a portfolio over a specified time horizon at given confidence levels. The table below sets out the VaR, at a 95% confidence level and a one-day time horizon, for the Group's trading and treasury portfolios. The VaR for the Group's trading portfolios includes idiosyncratic risk and is segregated by type of market risk exposure.

	Average £m	Period end £m	Maximum £m	Minimum £m
Trading VaR				
Interest rate	**20.7**	**26.3**	**36.5**	**12.1**
Credit spread	**37.2**	**40.4**	**51.2**	**26.0**
Currency	**4.5**	**8.7**	**10.5**	**1.2**
Equity	**12.3**	**9.4**	**19.9**	**6.0**
Commodity	**6.7**	**6.3**	**18.2**	**-**
Diversification effects		**(43.3)**		
2008	**44.6**	**47.8**	**60.9**	**29.9**
2007	21.6	45.7	50.1	13.2
Treasury VaR				
2008	**8.3**	**52.0**	**52.0**	**4.8**
2007	3.7	5.5	6.4	1.3

The Group's VaR should be interpreted in light of the limitations of the methodologies used. These limitations include:

- Historical data may not provide the best estimate of the joint distribution of risk factor changes in the future and may fail to capture the risk of possible extreme adverse market movements which have not occurred in the historical window used in the calculations.
- VaR using a one-day time horizon does not fully capture the market risk of positions that cannot be liquidated or hedged within one day.
- VaR using a 95% confidence level does not reflect the extent of potential losses beyond that percentile.

The Group largely computes the VaR of trading portfolios at the close of business and positions may change substantially during the course of the trading day. Controls are in place to limit the Group's intra-day exposure, such as the calculation of VaR for selected portfolios. These limitations and the nature of the VaR measure mean that the Group cannot guarantee that losses will not exceed the VaR amounts indicated. The Group undertakes stress testing to identify the potential for losses in excess of the VaR.

The Group's treasury activities include its money market business and the management of internal funds flow within the Group's businesses.

Other information

	2008	2007
Ordinary share price	**£0.494**	£3.72*
Number of ordinary shares in issue	**39,456m**	10,006m
Market capitalisation	**£19.5bn**	£44.4bn
Net asset value per ordinary share	**£1.15**	£3.74
Employee numbers in continuing operations (full time equivalents rounded to the nearest hundred)		
Global Banking & Markets	**20,200**	24,100
Global Transaction Services	**4,500**	3,700
UK Retail & Commercial Banking	**46,500**	46,200
US Retail & Commercial Banking	**17,600**	17,800
Europe & Middle East Retail & Commercial Banking	**7,900**	7,900
Asia Retail & Commercial Banking	**11,500**	8,900
RBS Insurance	**16,600**	17,300
Group Manufacturing	**44,900**	42,500
Centre	**4,300**	4,200
	174,000	172,600
Integration	**900**	-
Share of shared assets	**400**	1,200
RFS minority interest	**24,500**	21,600
Group total	**199,800**	195,400

* restated for the effect of the rights issue in June 2008 and the capitalisation issue in September 2008.

Statutory results

Financial information contained in this document does not constitute statutory accounts within the meaning of section 240 of the Companies Act 1985 ("the Act"). The statutory accounts for the year ended 31 December 2008 will be filed with the Registrar of Companies following the company's Annual General Meeting. The auditors have reported on these accounts: their report was unqualified and did not contain a statement under section 237(2) or (3) of the Act.

Other information (continued)

Reclassifications

Divisional results for 2007 have been restated to reflect transfers of operations and businesses between divisions in 2008. These changes do not affect the Group's results.

	Previously reported £m	Transfers £m	**Restated £m**
Global Banking & Markets			
- Net interest income	2,229	(15)	**2,214**
- Net fees and commissions receivable	8,687	(21)	**8,666**
- Staff costs	3,856	(3)	**3,853**
- Other costs	1,230	(117)	**1,113**
- Impairment losses before re-designated asset impairments	125	(3)	**122**
Contribution	3,564	87	**3,651**
Global Transaction Services			
- Net interest income	842	4	**846**
- Non-interest income	1,340	19	**1,359**
- Staff costs	357	10	**367**
- Other costs	164	13	**177**
- Impairment losses	12	3	**15**
Contribution	1,649	(3)	**1,646**
UK Retail Banking			
- Net interest income	4,173	(1)	**4,172**
- Staff costs	1,225	41	**1,266**
- Other costs	542	3	**545**
Contribution	3,844	(45)	**3,799**
UK Corporate & Commercial Banking			
- Net interest income	1,988	2	**1,990**
- Staff costs	479	(48)	**431**
- Other costs	473	(6)	**467**
Contribution	1,873	56	**1,929**
UK Wealth			
- Non-interest income	278	3	**281**
- Staff costs	224	(2)	**222**
- Other costs	66	(2)	**64**
Contribution	490	7	**497**
US Retail & Commercial Banking			
- Net interest income	1,936	(1)	**1,935**
- Non-interest income	850	(4)	**846**
- Staff costs	601	(3)	**598**
- Other costs	368	(4)	**364**
- Impairment losses – SBO	164	(1)	**163**
Contribution	1,476	3	**1,479**
Europe & Middle East Retail & Commercial Banking			
- Staff costs	334	(4)	**330**
- Other costs	170	3	**173**
Contribution	798	1	**799**

Reclassifications (continued)

	Previously reported £m	Transfers £m	**Restated £m**
Asia Retail & Commercial Banking			
- Net interest income	285	9	**294**
- Non-interest income	395	6	**401**
- Staff costs	226	11	**237**
- Other costs	130	5	**135**
Contribution	205	(1)	**204**

	Previously reported £m	Transfers £m	**Restated £m**
Manufacturing			
- Staff costs	1,075	146	**1,221**
- Other costs	3,212	48	**3,260**
Contribution	(4,287)	(194)	**(4,481)**

	Previously reported £m	Transfers £m	**Restated £m**
Centre			
- Departmental costs	582	38	**620**
- Other corporate costs	(144)	(127)	**(271)**
Contribution	(1,641)	89	**(1,552)**

Analysis of Divisional Contribution

The table below provides an analysis of the divisional contribution for 2008 by the main income statement captions. The proforma divisional income statements on pages 23 to 46 reflect certain presentational reallocations as described in the notes below. These do not affect the overall contribution.

	Net interest income £m	Non-interest income £m	Total income £m	Operating expenses £m	Net insurance claims £m	Impairment losses £m	Contribution £m
Global Banking & Markets (1)	3,490	(6,010)	(2,520)	(4,352)	-	(3,643)	(10,515)
Global Transaction Services	909	1,563	2,472	(594)	-	(60)	1,818
UK Retail & Commercial Banking (2)	6,999	3,999	10,998	(3,171)	(184)	(1,964)	5,679
US Retail & Commercial Banking	2,106	904	3,010	(1,086)	-	(1,041)	883
Europe & Middle East Retail & Commercial Banking (3)	1,087	431	1,518	(563)	-	(526)	429
Asia Retail & Commercial Banking	379	402	781	(483)	-	(171)	127
RBS Insurance	647	4,919	5,566	(771)	(3,733)	(42)	1,020
Group Manufacturing	(202)	(11)	(213)	(4,580)	-	-	(4,793)
Central items (4)	524	(902)	(378)	(316)	-	19	(675)
Group operating loss – pro forma	15,939	5,295	21,234	(15,916)	(3,917)	(7,428)	(6,027)
Share of shared assets	(175)	(18)	(193)	(103)	-	(4)	(300)
Amortisation of intangibles	-	-	-	(443)	-	-	(443)
Integration and restructuring costs	-	-	-	(1,357)	-	-	(1,357)
Write-down of goodwill and other intangible assets	-	-	-	(16,911)	-	-	(16,911)
	15,764	5,277	21,041	(34,730)	(3,917)	(7,432)	(25,038)
RFS Holdings minority interest	2,911	1,916	4,827	(19,303)	(513)	(640)	(15,629)
Total statutory	18,675	7,193	25,868	(54,033)	(4,430)	(8,072)	(40,667)

Notes :

(1) reallocation of £544 million between net interest income and non-interest income in respect of funding costs of rentals assets, £404 million, and to record interest on financial assets and liabilities designated as at fair value through profit or loss, £140 million.

(2) reallocation of £91 million between net interest income and non-interest income of funding costs of rental assets and netting of bancassurance claims of £184 million against non-interest income.

(3) reallocation of £65 million between net interest income and non-interest income to record interest on financial assets and liabilities designated as at fair value through profit or loss.

(4) includes the gain of fair value of own debt, £875 million and profit on sale of investment in Tesco Personal Finance of £442 million.

Other information (continued)

Financial calendar

Annual General Meeting at 1pm at the EICC, Morrison Street, Edinburgh	3 April 2009
2009 first quarter interim management statement	May 2009
2009 interim results announcement	7 August 2009
2009 third quarter interim management statement	November 2009

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25 February 2009

THE ROYAL BANK OF SCOTLAND GROUP plc

APPENDIX 1 Reconciliations of pro forma to statutory income statements and balance sheets

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2008

	Pro forma £m	RFS minority interest £m	RBS share of shared assets £m	Credit market write-downs and one-off items £m	Intangibles amortisation and integration costs £m	Write-down of goodwill and other intangible assets £m	**Statutory £m**
Net interest income	**15,939**	2,911	(175)	-	-	-	**18,675**
Non-interest income (excluding insurance net premium income)	**5,227**	1,299	(18)	(5,641)		-	**867**
Insurance net premium income	**5,709**	617	-	-	-	-	**6,326**
Non-interest income excluding credit market write-downs and one-off items	**10,936**	1,916	(18)	(5,641)	-	-	**7,193**
Credit market write-downs and one-off items	**(5,641)**	-	-	5,641	-	-	**-**
Non-interest income	**5,295**	1,916	(18)	-	-	-	**7,193**
Total income	**21,234**	4,827	(193)	-	-	-	**25,868**
Operating expenses	**15,916**	19,303	103	-	1,800	16,911	**54,033**
Profit/(loss) before other operating charges	**5,318**	(14,476)	(296)	-	(1,800)	(16,911)	**(28,165)**
Insurance net claims	**3,917**	513	-	-	-	-	**4,430**
Operating profit/(loss) before impairment losses	**1,401**	(14,989)	(296)	-	(1,800)	(16,911)	**(32,595)**
Impairment losses before reclassified asset impairment	**6,962**	640	4	466	-	-	**8,072**
Impairment losses on reclassified assets	**466**	-	-	(466)	-	-	**-**
Group operating loss	**(6,027)**	(15,629)	(300)	-	(1,800)	(16,911)	**(40,667)**
Amortisation of purchased intangible assets	**443**	-	-	-	(443)	-	-
Integration costs	**1,050**	-	-	-	(1,050)	-	-
Restructuring costs	**307**	-	-	-	(307)	-	-
Write-down of goodwill and other intangible assets	**16,911**	-	-	-	-	(16,911)	-
Share of shared assets	**300**	-	(300)	-	-	-	-
Loss before tax	**(25,038)**	(15,629)	-	-	-	-	**(40,667)**
Tax	**(1,995)**	(328)	-	-	-	-	**(2,323)**
Loss from continuing operations	**(23,043)**	(15,301)	-	-	-	-	**(38,344)**
Profit/(loss) from discontinued operations, net of tax	**-**	4,057	(86)	-	-	-	**3,971**
Loss for the period	**(23,043)**	(11,244)	(86)	-	-	-	**(34,373)**
Minority interests	**412**	(11,244)	-	-	-	-	**(10,832)**
Preference dividends	**596**	-	-	-	-	-	**596**
Loss attributable to ordinary shareholders	**(24,051)**	-	(86)	-	-	-	**(24,137)**

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2007

	Pro forma £m	289 days RBS share of ABN AMRO £m	Funding adjustment £m	76 days RBS share of shared assets £m	76 days RFS minority interest £m	Credit market write-downs and one-off items £m	Intangibles amortisation and integration costs £m	**Restated Statutory £m**
Net interest income	**12,382**	(1,350)	477	15	545	-	-	**12,069**
Non-interest income (excluding insurance net premium income)	**15,200**	(1,866)	16	(54)	182	(1,268)	-	**12,210**
Insurance net premium income	**5,982**	-	-	-	105	-	-	**6,087**
Non-interest income excluding credit market write-downs and one-off items	**21,182**	(1,866)	16	(54)	287	(1,268)	-	**18,297**
Credit market write-downs and one-off items	**(1,268)**	-	-	-	-	1,268	-	**-**
Non-interest income	**19,914**	(1,866)	16	(54)	287	-	-	**18,297**
Total income	**32,296**	(3,216)	493	(39)	832	-	-	**30,366**
Operating expenses excluding one-off items	**16,618**	(3,376)	-	37	535	(242)	370	**13,942**
One-off items	**(242)**	-	-	-	-	242	-	**-**
Profit before other operating charges	**15,920**	160	493	(76)	297	-	(370)	**16,424**
Insurance net claims	**4,528**	-	-	-	96	-	-	**4,624**
Operating profit before impairment losses	**11,392**	160	493	(76)	201	-	(370)	**11,800**
Impairment losses	**2,104**	(171)	-	(3)	38	-	-	**1,968**
Group operating profit	**9,288**	331	493	(73)	163	-	(370)	**9,832**
Amortisation of purchased intangible assets	**124**	53	-	-	85	-	(262)	**-**
Integration costs	**108**	-	-	-	-	-	(108)	**-**
Share of shared assets	**94**	(21)	-	(73)	-	-	-	**-**
Profit before tax	**8,962**	299	493	-	78	-	-	**9,832**
Tax	**1,709**	193	148	-	(6)	-	-	**2,044**
Profit from continuing operations	**7,253**	106	345	-	84	-	-	**7,788**
Loss from discontinued operations, net of tax	-	-	-	-	76	-	-	**76**
Profit for the period	**7,253**	106	345	-	8	-	-	**7,712**
Minority interests	**184**	(26)	-	-	5	-	-	**163**
Preference dividends	**246**	-	-	-	-	-	-	**246**
Profit attributable to ordinary shareholders	**6,823**	132	345	-	3	-	-	**7,303**

BALANCE SHEET AS AT 31 DECEMBER 2008

	Pro forma £m	Transfers £m	Shared assets £m	Statutory £m
Assets				
Cash and balances at central banks	**11,830**	570	-	**12,400**
Loans and advances to banks	**129,408**	8,698	91	**138,197**
Net loans and advances to customers	**691,876**	143,433	100	**835,409**
Reverse repurchase agreements and stock borrowing	**39,289**	24	-	**39,313**
Loans and advances to customers	**731,165**	143,457	100	**874,722**
Debt securities	**253,098**	14,390	61	**267,549**
Equity shares	**22,094**	4,132	104	**26,330**
Settlement balances	**17,812**	20	-	**17,832**
Derivatives	**991,493**	1,064	2	**992,559**
Intangible assets	**16,386**	3,634	29	**20,049**
Property, plant and equipment	**17,169**	1,768	12	**18,949**
Prepayments, accrued income and other assets	**20,715**	2,829	858	**24,402**
Deferred taxation	**5,409**	1,296	377	**7,082**
Assets of disposal groups	**67**	1,101	413	**1,581**
	2,216,646	182,959	2,047	**2,401,652**
Share of shared assets	**2,047**	-	(2,047)	**-**
Total assets	**2,218,693**	182,959	-	**2,401,652**
Liabilities				
Deposits by banks	**261,934**	(4,565)	675	**258,044**
Net customer accounts	**460,318**	121,051	-	**581,369**
Repurchase agreements and stock lending	**58,143**	-	-	**58,143**
Customer accounts	**518,461**	121,051	-	**639,512**
Debt securities in issue	**269,188**	30,831	270	**300,289**
Settlement balances and short positions	**54,264**	13	-	**54,277**
Derivatives	**969,396**	1,955	13	**971,364**
Accruals, deferred income and other liabilities	**23,453**	7,342	687	**31,482**
Retirement benefit liabilities	**1,547**	468	17	**2,032**
Deferred taxation	**2,930**	988	247	**4,165**
Insurance liabilities	**7,480**	2,496	-	**9,976**
Subordinated liabilities	**43,678**	5,476	-	**49,154**
Liabilities of disposal groups	**-**	721	138	**859**
	2,152,331	166,776	2,047	**2,321,154**
Share of shared assets	**2,047**	-	(2,047)	**-**
Total liabilities	**2,154,378**	166,776	-	**2,321,154**
Equity:				
Minority interests	**5,436**	16,183	-	**21,619**
Owners' equity	**58,879**	-	-	**58,879**
Total equity	**64,315**	16,183	-	**80,498**
Total liabilities and equity	**2,218,693**	182,959	-	**2,401,652**

BALANCE SHEET AS AT 31 DECEMBER 2007

	Pro forma **£m**	Transfers £m	Shared assets £m	**Statutory** **£m**
Assets				
Cash and balances at central banks	**14,240**	3,626	-	**17,866**
Loans and advances to banks	**211,000**	2,599	5,861	**219,460**
Net loans and advances to customers	**558,075**	126,711	1,395	**686,181**
Reverse repurchase agreements and stock borrowing	**142,116**	241	-	**142,357**
Loans and advances to customers	**700,191**	126,952	1,395	**828,538**
Debt securities	**240,801**	35,957	17,898	**294,656**
Equity shares	**46,704**	5,532	790	**53,026**
Settlement balances	**16,533**	56	-	**16,589**
Derivatives	**275,146**	741	1,515	**277,402**
Intangible assets	**27,610**	22,198	108	**49,916**
Property, plant and equipment	**16,913**	1,826	6	**18,745**
Prepayments, accrued income and other assets	**16,631**	285	(1,254)	**15,662**
Deferred taxation	**1,680**	1,454	(15)	**3,119**
Assets of disposal groups	**395**	44,537	918	**45,850**
	1,567,844	245,763	27,222	**1,840,829**
Share of shared assets	**27,222**	-	(27,222)	**-**
Total assets	**1,595,066**	245,763	-	**1,840,829**
Liabilities				
Deposits by banks	**303,499**	5,813	2,982	**312,294**
Net customer accounts	**437,060**	108,486	1,901	**547,447**
Repurchase agreements and stock lending	**120,062**	14,854	-	**134,916**
Customer accounts	**557,122**	123,340	1,901	**682,363**
Debt securities in issue	**220,577**	38,003	15,592	**274,172**
Settlement balances and short positions	**89,829**	739	453	**91,021**
Derivatives	**270,814**	369	869	**272,052**
Accruals, deferred income and other liabilities	**27,873**	5,330	1,005	**34,208**
Retirement benefit liabilities	**265**	82	113	**460**
Deferred taxation	**3,728**	1,471	201	**5,400**
Insurance liabilities	**7,650**	2,512	-	**10,162**
Subordinated liabilities	**28,052**	6,368	3,623	**38,043**
Liabilities of disposal groups	**6**	28,739	483	**29,228**
	1,509,415	212,766	27,222	**1,749,403**
Share of shared assets	**27,222**	-	(27,222)	**-**
Total liabilities	**1,536,637**	212,766	-	**1,749,403**
Equity:				
Minority interests	**5,391**	32,997	-	**38,388**
Owners' equity	**53,038**	-	-	**53,038**
Total equity	**58,429**	32,997	-	**91,426**
Total liabilities and equity	**1,595,066**	245,763	-	**1,840,829**

THE ROYAL BANK OF SCOTLAND GROUP plc

APPENDIX 2

Contents

Note: the following acronyms are used in this supplement

ABCP	Asset-backed commercial paper
ABS	Asset-backed securities
CDO	Collateralised debt obligations
CDS	Credit default swap
CLO	Collateralised loan obligations
CP	Commercial paper
CMBS	Commercial mortgage-backed securities
Fannie Mae	Federal National Mortgage Association
Freddie Mac	Federal Home Loan Mortgage Corporation
Ginnie Mae	Government National Mortgage Association
GSE	Government Sponsored Entity
IASB	International Accounting Standards Board
RMBS	Residential mortgage-backed securities
SIV	Structured investment vehicle
SPE	Special purpose entity
US agencies	Ginnie Mae, Fannie Mae, Freddie Mac and similar entities

Credit market and related exposures

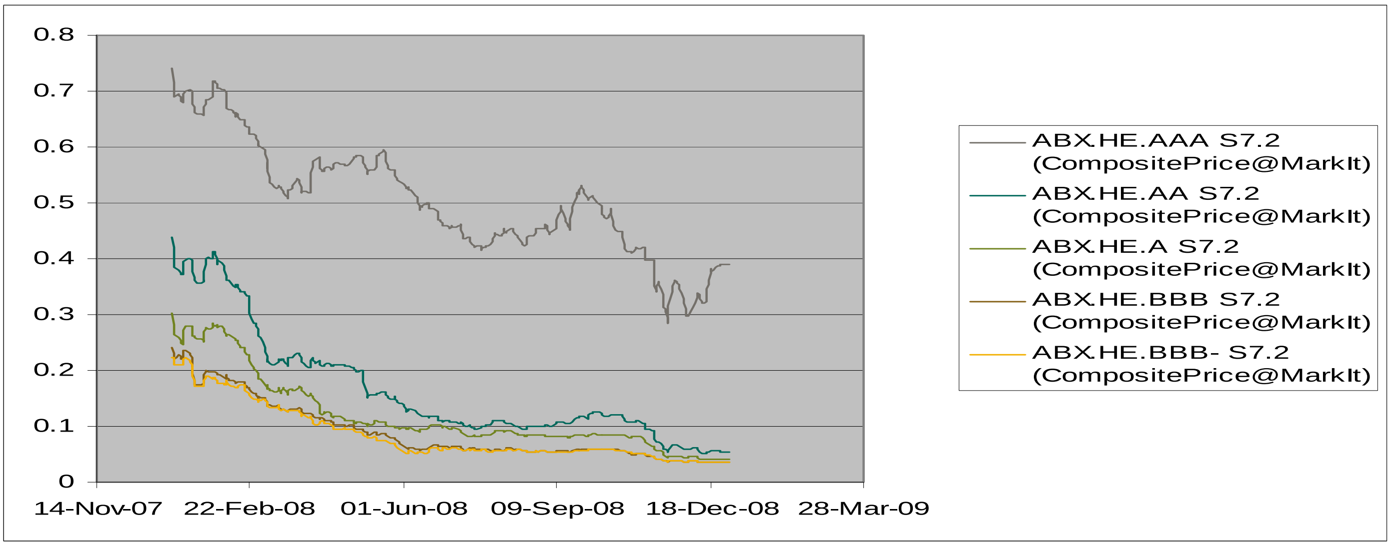
1. Explanatory note

These disclosures provide information for certain of the Group's business activities affected by the unprecedented market events of 2008, the majority of which arose within Global Banking and Markets (GBM), and supplement Credit market exposures table on page 47. The disclosures are focused around GBM's credit markets activities, including the conduit business, which have been particularly affected by the widespread market disruptions, as well as similar exposures in US Retail & Commercial and Group Treasury and, financial instruments where the valuation includes a higher level of subjectivity or complexity.

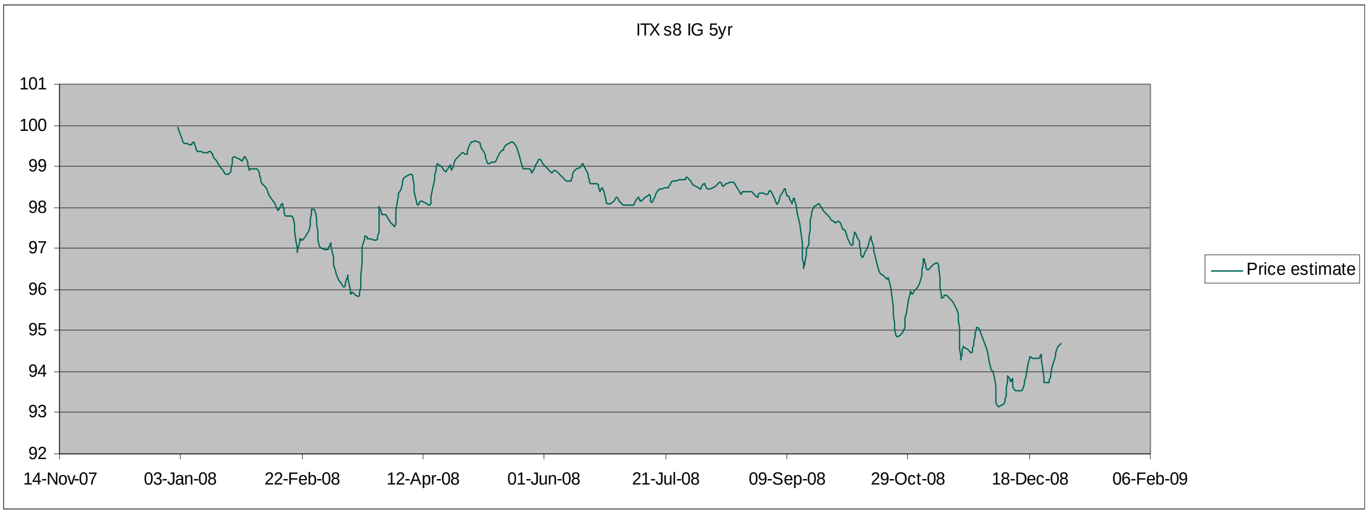
In preparing these disclosures, the Group took into consideration the leading practice disclosure recommendations of the Financial Stability Forum issued in April 2008 and the report of the IASB Expert Advisory Panel 'Measuring and disclosing fair value of financial instruments in markets that are no longer active' issued in October 2008. All the disclosures in this appendix are audited except for section 2, 3.6, 8.3 and 8.4.

2. Market background

Overall, 2008 has been characterised by rapid dislocation in financial markets. In many cases, the dramatic liquidity squeeze and rise in funding costs for financial institutions has resulted in reluctance or inability of market participants to transact, and has adversely affected the performance of most financial institutions globally, including the Group. Stock markets have experienced extraordinary falls, and levels of volatility have been at record highs. Commodity prices have reduced sharply in the second half of the year, and credit spreads continued to widen. Market perception of counterparty risk increased and the failure of major credit protection providers caused fair value losses for the Group and other market participants and further increased the costs of mitigating credit exposure. Sustained falls globally in both residential and commercial real estate prices, fund valuations and worsening loan performance combined with a sustained lack of liquidity in the market, resulted in a greater amount of assets being valued at significantly lower prices.
An indication of the continued decline in the price of asset backed securities (ABS), in particular those collateralised with sub-prime assets, is shown in the graph below. While not fully representative of the Group's ABS exposures or pricing basis, the ABX series of indices charted in the graph show, in bond price terms, how differently rated ABS referencing US sub-prime mortgages securitised in 2007 have performed during the year.



The graph below provides an indication of the change in credit worthiness of corporate entities to which the Group has significant exposure through its credit products in the form of credit derivatives and bonds. The MarkiT iTraxx Europe graph demonstrates the impact of the movement of credit spreads in price terms for a basket of European corporate entities (prices rebased to 100 at the beginning of the year).



The first quarter of 2008 saw a continuation of credit and liquidity shortages experienced during 2007, culminating in the collapse of Bear Stearns in March. The centre of the credit issues remained the ABS market with worsening US economic data supporting higher levels of default expectation in the property market. However, these default expectations started to go beyond the sub-prime market with Alt A and other non-conforming classes of loans particularly seeing significant price deterioration. In addition, wider economic concerns led to heavy fair value losses in the commercial mortgage backed securities market, in corporate debt and in leveraged loan exposures. Following this tightening of conditions, the Group incurred significant losses in March [and took steps in April to materially strengthen its capital base through a £12 billion rights issue which was completed in June].

During the second quarter ABS prices initially rallied and steadied, however towards the end of the quarter a negative house price trend in the UK became clear, and in the US, market reaction to sub-prime mortgages extended to prime and near prime lending. Corporate credit spreads followed a similar pattern reacting to rising oil prices, inflationary pressures and continuing high LIBOR despite base rate cuts to 5% in April.

Credit spreads continued to widen across the market through the third quarter and liquidity levels reduced further, resulting in pressure on banks and economies worldwide. This culminated in the demise of Lehman Brothers in September and further market consolidation and global state intervention to provide support to the banking sector.

During the fourth quarter there was a continued lack of confidence in the inter-bank market, with demand for stable investments resulting in US treasuries reaching negative spreads. Corporate and ABS prices fell further particularly in the last two months of the year increasing pressure on banks' capital positions. The Group moved to strengthen its capital position through an open offer to raise £15 billion, underwritten by the UK government. The year concluded with S&P downgrading the credit ratings of eleven global banks, including the Group.

3. Asset-backed exposures

3.1 Significant risk concentrations and losses

The Group's credit markets activities gives rise to risk concentrations that have been particularly affected by the market turmoil experienced since the second half of 2007. 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.

During 2008, certain assets identified as being high risk were also transferred to a centrally managed asset unit, set up to provide specific management of this portfolio of higher risk assets. Transferred assets are predominantly ABS and associated protection purchased from monoline insurers and other counterparties.

The tables below summarise the net exposures and balance sheet carrying values of these securities by measurement classification and references to sections with further information on specific products.

		Held-for-trading		**Available-for-sale**		**Loans and receivables**		**Designated at fair value**		**All ABS**	
	Section	**2008**	2007	**2008**	2007	**2008**	2007	**2008**	2007	**2008**	2007
Net exposure		**£m**	£m	**£m**	£m	**£m**	£m	**£m**	£m	**£m**	£m
RMBS	3.2	**24,462**	35,105	**44,450**	27,875	**2,578**	5	**182**	90	**71,672**	63,075
CMBS	3.3	**1,178**	2,749	**918**	977	**1,437**	626	**13**	47	**3,546**	4,399
CDOs& CLOs	3.4	**2,463**	7,288	**2,538**	2,174	**1,282**	-	**-**	23	**6,283**	9,485
Other ABS	3.5	**195**	3,479	**6,572**	5,579	**3,621**	72	**40**	186	**10,428**	9,316
Total		**28,298**	48,621	**54,478**	36,605	**8,918**	703	**235**	346	**91,929**	86,275
Carrying value											
RMBS	3.2	**27,849**	37,280	**44,791**	27,880	**2,618**	5	**182**	90	**75,440**	65,255
CMBS	3.3	**2,751**	3,916	**1,126**	976	**1,437**	626	**13**	37	**5,327**	5,555
CDOs & CLOs	3.4	**7,774**	15,477	**9,579**	2,173	**1,284**	-	**-**	26	**18,637**	17,676
Other ABS	3.5	**1,505**	5,758	**6,572**	5,579	**3,621**	72	**41**	186	**11,739**	11,595
Total		**39,879**	62,431	**62,068**	36,608	**8,960**	703	**236**	339	**111,143**	100,081

Notes:

(1) Net exposures is carrying value after taking account of hedge protection purchased from monolines and other counterparties but excludes the effect of counterparty credit valuation adjustment. The protection provides credit protection against the notional and interest cash flows due to the holders of debt instruments in the event of default by the debt security counterparty. The value of the protection is based on the underlying instrument being protected.

(2) Carrying value is the amount recorded on the balance sheet

(3) Certain instruments have been reclassified from the held-for-trading category to loans and receivables or available-for-sale categories, as permitted by the amendment to IAS 39 issued in October 2008, therefore affecting comparability by measurement classification. Further information on the reclassifications is provided in section 6.

Asset backed securities ('ABS') are securities that represent an interest in an underlying pool of referenced assets. The referenced pool can comprise any assets which attract a set of associated cash flows but are commonly pools of residential or commercial mortgages and, in the case of collateralised debt obligations ('CDOs'), the referenced pool may be ABS or other classes of assets. The process by which the risks and rewards of the pool are passed on to investors via the issuance of securities with varying seniority is commonly referred to as securitisation.

During 2008, as the problems in the sub-prime sector spread to other asset classes on a global basis and credit spreads widened due to concerns over creditworthiness of underlying assets, securitisation volumes continued to be thin. Over the preceding years GBM had established itself as an active arranger of third-party securitisations and a secondary dealer in these securities, and GBM had therefore accumulated assets that became difficult to sell given market conditions.

The Group has exposures to ABS which are predominantly debt securities but can be held in derivative form. These positions had been acquired primarily through the Group's activities in the US leveraged finance market which were expanded during 2007. These include residential mortgage backed securities ('RMBS'), commercial mortgage backed securities ('CMBS'), ABS CDOs, collateralised loan obligations ('CLOs') and other ABS. In many cases the risk on these assets is hedged via credit derivative protection purchased over the specific asset or relevant ABS indices. The counterparty to some of these hedge transactions are monoline insurers (see section 4).

The net exposure of the Group's holdings of ABS increased from £86.3 billion at 31 December 2007 to £91.9 billion by 31 December 2008, where underlying reductions have been more than offset by the effect of exchange rates. The net exposure incorporates hedge protection but excludes counterparty credit valuation adjustments.

Through a sustained de-risking exercise, the Group made reductions to the overall risk through a combination of direct asset sales and switching to lower risk assets through trading activities. As a large proportion of the ABS are denominated in US dollars, these reductions in exposure were partially offset due to the movement in the exchange rate against sterling.

The majority of the Group's RMBS portfolio at 31 December 2008, in terms of net exposure, was AAA rated guaranteed or effectively guaranteed securities of £58.8 billion, comprising:

- £41.2 billion of US agency securities
- £7.6 billion of Dutch government guaranteed RMBS
- £10.0 billion of European mortgage covered bonds issued by financial institutions

The tables below analyses carrying values of these debt securities by measurement classification and rating[(1)] and fair value hierarchy level[(2)].

	RMBS				CMBS	CDOs & CLOs	Other ABS	Total
	Sub-prime	Non conforming	Prime Guaranteed	Prime Other				
31 December 2008	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
AAA rated[(1)]								
Held-for-trading	393	203	18,622	6,226	2,306	4,699	380	32,829
Available-for-sale	522	1,914	22,546	18,764	982	6,458	4,826	56,012
Loans and receivables	431	1,415	-	476	406	651	1,443	4,822
Designated at fair value	16	-	-	166	9	-	-	191
	1,362	3,532	41,168	25,632	3,703	11,808	6,649	93,854
BBB- and above rated[(1)]								
Held-for-trading	564	79	-	985	407	1,439	890	4,364
Available-for-sale	267	194	-	338	144	1,642	1,292	3,877
Loans and receivables	105	64	-	94	1,031	561	1,296	3,151
Designated at fair value	-	-	-	-	4	-	41	45
	936	337	-	1,417	1,586	3,642	3,519	11,437
Non-investment grade[(1)]								
Held-for-trading	636	69	-	59	38	1,299	120	2,221
Available-for-sale	124	74	-	47	-	1,057	50	1,352
Loans and receivables	30	3	-	-	-	-	73	106
Designated at fair value	-	-	-	-	-	-	-	-
	790	146	-	106	38	2,356	243	3,679
Not publicly rated								
Held-for-trading	1	1	9	2	-	338	115	466
Available-for-sale	-	1	-	-	-	421	404	826
Loans and receivables	-	-	-	-	1	71	811	883
Designated at fair value	-	-	-	-	-	-	-	-
	1	2	9	2	1	830	1,330	2,175
Total								
Held-for-trading	1,594	352	18,631	7,272	2,751	7,774	1,505	39,879
Available-for-sale	913	2,183	22,546	19,149	1,126	9,579	6,572	62,068
Loans and receivables	566	1,482	-	570	1,437	1,284	3,621	8,960
Designated at fair value	16	-	-	166	13	-	41	236
Total	3,089	4,017	41,177	27,157	5,327	18,637	11,739	111,143
Of which carried at fair value:								
Level 2[(2)]	2,459	2,485	40,942	26,442	3,315	14,643	6,677	96,963
Level 3[(3)]	64	50	235	145	574	2,710	1,441	5,220
	2,523	2,535	41,177	26,587	3,889	17,353	8,118	102,183

Notes:
(1) Credit ratings are based on those from rating agencies Standard & Poor's (S&P), Moody's and Fitch and have been mapped onto S&P scale
(2) Valuation is based significantly on observable market data. Instruments in this category are valued 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 valuation are directly or indirectly based on observable market data.
(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

31 December 2007[1]	RMBS Sub-prime £m	RMBS Non conforming £m	RMBS Guaranteed £m	RMBS Other £m	CMBS £m	CDOs & CLOs £m	Other ABS £m	Total £m
AAA rated[2]								
Held-for-trading	1,790	2,093	15,502	12,951	3,285	12,067	3,495	51,183
Available-for-sale	139	865	16,545	10,313	964	2,152	5,073	36,051
Loans and receivables	-	-	-	-	-	-	-	-
Designated at fair value	-	-	-	72	37	7	-	116
	1,929	2,958	32,047	23,336	4,286	14,226	8,568	87,349
BBB- and above rated[2]								
Held-for-trading	2,476	530	-	557	574	1,509	1,077	6,723
Available-for-sale	-	-	-	18	13	1	206	238
Loans and receivables	-	-	-	-	626	-	-	626
Designated at fair value	2	-	-	-	-	17	-	19
	2,478	530	-	575	1,213	1,527	1,283	7,606
Non-investment grade[2]								
Held-for-trading	616	146	-	27	35	1,082	91	1,997
Available-for-sale	-	-	-	-	-	-	14	14
Loans and receivables	5	-	-	-	-	-	72	77
Designated at fair value	16	-	-	-	-	-	-	16
	637	146	-	27	35	1082	177	2,104
Not publicly rated								
Held-for-trading	192	144	126	131	22	819	1,096	2,530
Available-for-sale	-	-	-	-	-	20	284	304
Loans and receivables	-	-	-	-	-	-	-	-
Designated at fair value	-	-	-	-	-	2	186	188
	192	144	126	131	22	841	1,566	3,022
Total								
Held-for-trading	5,073	2,913	15,627	13,666	3,916	15,477	5,758	62,430
Available-for-sale	139	865	16,545	10,331	976	2,174	5,577	36,607
Loans and receivables	5	-	-	-	626	-	72	703
Designated at fair value	19	-	-	72	37	26	186	340
Total	5,236	3,778	32,172	24,069	5,556	17,677	11,593	100,081
Of which:								
Level 2[3]	5,171	3,598	32,172	24,069	4,929	15,927	11,391	97,258
Level 3[4]	59	180	-	-	-	1,750	130	2,119
	5,230	3,778	32,173	24,069	4,929	17,677	11,520	99,377

Notes:

(1) 31 December 2007 includes approximately £19 billion of AAA rated guaranteed, covered bonds and other RMBS relating to ABM AMRO Group Treasury liquidity portfolio, included within Shared assets at that time but which were transferred to RBS in the first half of 2008. Information for 31 December 2007 has been aligned to presentation adopted for 2008 reporting

(2) Credit ratings are based on those from rating agencies Standard & Poor's (S&P), Moody's and Fitch and have been mapped onto S&P scale

(3) Valuation is based significantly on observable market data. Instruments in this category are valued 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 valuation are directly or indirectly based on observable market data.

(4) 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

3.2 Residential mortgage-backed securities

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 are described below. As can be seen from the tables below, the Group's RMBS portfolio covers a range of geographic locations and there different categories used to classify the exposures depending on the geographical region of the underlying mortgage. The categories are described below. The US market has more established definitions of differing underlying mortgage quality and these are used as the basis for the Group's RMBS categorisation.

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

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

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

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

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

The tables below shows the Group's RMBS net exposures and carrying values by measurement classification, underlying asset type, geographical location of the property that the mortgage is secured against, and the year in which the underlying mortgage was originated.

	31 December 2008					31 December 2007				
	Sub-prime	**Non conforming**	**Prime**		**Total**	Sub-prime	Non conforming	Prime		Total
TOTAL			**Guaranteed(2)**	**Other(3)**				Guaranteed(2)	Other(3)	
Net exposure	**£m**	**£m**	**£m**	**£m**		£m	£m	£m	£m	£m
Held-for-trading	**344**	**350**	**18,557**	**4,859**	**24,110**	3,496	2,917	15,627	13,066	34,941
Available-for-sale	**571**	**2,184**	**22,546**	**19,116**	**44,417**	139	865	16,540	10,332	27,876
Loans and receivables	**526**	**1,481**	**-**	**870**	**2,877**	25	-	-	-	25
Designated at fair value	**16**	**-**	**-**	**166**	**182**	18	-	-	72	90
	1,457	**4,015**	**41,103**	**25,011**	**71,586**	3,673	3,776	32,013	23,470	62,932
Carrying values										
Held-for-trading	**1,594**	**352**	**18,631**	**7,272**	**27,849**	5,073	2,913	15,627	13,666	37,279
Available-for-sale	**913**	**2,184**	**22,546**	**19,149**	**44,792**	139	865	16,545	10,331	27,880
Loans and receivables	**566**	**1,482**	**-**	**570**	**2,618**	5	-	-	-	5
Designated at fair value	**16**	**-**	**-**	**166**	**182**	18	-	-	72	90
	3,089	**4,018**	**41,177**	**27,157**	**75,441**	5,235	3,778	32,172	24,069	65,254

Notes

(1) Net exposures reflect the effect of hedge protection purchased from monolines and other counterparties but excludes the effect of counterparty credit valuation adjustment.

(2) Prime guaranteed exposures and carrying values include:

(a) £7.6 billion (2007 - £6.0 billion) available-for-sale exposures guaranteed by the Dutch government

(b) £ 5.7 billion (2007 - £5.0 billion) guaranteed by US government via Ginnie Mae of which £0.5 billion (2007 - £0.3 billion) are held-for-trading

(c) £ 27.8 billion (2007 - £ 21.0 million) effectively guaranteed by the US government via its support for Freddie Mac and Fannie Mae of which £17.9 billon (2007 - £15.1 billion) are held-for-trading

(3) Other prime mortgage exposures include £10.0 billion (2007 - £7.8 billion) covered European mortgage bonds

	31 December 2008					31 December 2007				
	Sub-prime	**Alt-A**	**Prime**		**Total**	**Sub-prime**	**Alt-A**	Prime		Total
			Guaranteed	**Other**				Guaranteed	Other	
United States	**£m**	**£m**	**£m**	**£m**		£m	£m	£m	£m	£m
Net exposure										
Held-for-trading	**302**	**346**	**18,577**	**968**	**20,193**	2,953	2,189	15,502	1,419	22,063
Available-for-sale	**53**	**760**	**14,887**	**4,409**	**20,109**	-	640	10,504	1,359	12,503
Loans and receivables	**3**	**-**	**-**	**215**	**218**	-	-	-	-	-
	358	**1,106**	**33,464**	**5,592**	**40,520**	2,953	2,829	26,006	2,778	35,889
Carrying values										
Held-for-trading	**1,427**	**351**	**18,577**	**1,043**	**21,398**	4,277	2,189	15,502	1,419	23,387
Available-for-sale	**394**	**760**	**14,887**	**4,409**	**20,450**	-	640	10,504	1,359	12,503
Loans and receivables	**3**	**-**	**-**	**215**	**218**	-	-		-	-
	1,824	**1,111**	**33,464**	**5,667**	**42,066**	4,277	2,829	26,006	2,778	35,890
Of which originated in:										
- 2004 and earlier	**474**	**122**	**5,534**	**709**	**6,839**	745	165	2,532	406	3,848
- 2005	**259**	**718**	**6,014**	**2,675**	**9,666**	1,065	437	3,209	275	4,987
- 2006	**718**	**115**	**1,689**	**614**	**3,136**	1,734	1,188	5,557	1,017	9,496
- 2007 and later	**373**	**156**	**20,227**	**1,669**	**22,425**	732	1,039	14,707	1,080	17,558
	1,824	**1,111**	**33,464**	**5,667**	**42,066**	4,277	2,829	26,005	2,778	35,889

	31 December 2008				31 December 2007			
	Sub-prime	**Non conforming**	**Prime**	**Total**	Sub-prime	Non conforming	Prime	Total
United Kingdom	**£m**	**£m**	**£m**		£m	£m	£m	£m
Net exposure								
Held-for-trading	**33**	**-**	**258**	**291**	150	724	2,411	3,285
Available-for-sale	**154**	**1,424**	**3,446**	**5,024**	7	157	930	1,094
Loans and receivables	**205**	**1,482**	**118**	**1,805**	5	-	-	5
Designated at fair value	**16**	**-**	**166**	**182**	18	-	72	90
	408	**2,906**	**3,988**	**7,303**	180	881	3,389	4,474
Carrying values								
Held-for-trading	**70**	**-**	**1,345**	**1,415**	150	724	2,740	3,614
Available-for-sale	**154**	**1,424**	**3,446**	**5,024**	7	157	935	1,100
Loans and receivables	**205**	**1,482**	**118**	**1,805**	5	-	-	5
Designated at fair value	**16**	**-**	**166**	**182**	18	-	72	90
	445	**2,906**	**5,075**	**8,426**	180	881	3,747	4,809
Of which originated in:								
- 2004 and earlier	**72**	**-**	**815**	**887**	13	22	911	946
- 2005	**42**	**653**	**1,000**	**1,695**	1	10	512	523
- 2006	**209**	**757**	**2,308**	**3,274**	49	110	1,256	1,415
- 2007 and later	**122**	**1,496**	**952**	**2,570**	117	738	1,068	1,923
	445	**2,906**	**5,075**	**8,426**	180	881	3,747	4,807

Europe	31 December 2008 Sub-prime	Prime Guaranteed(1)	Covered(2)	Other	Total	31 December 2007 Sub-prime	Prime Guaranteed(1)	Covered(2)	Other	Total
	£m	£m	£m	£m		£m	£m	£m	£m	£m
Net exposure										
Held-for-trading	**10**	**-**	**-**	**3,897**	**3,907**	321	-	-	9,157	9,478
Available-for-sale	**57**	**7,642**	**10,040**	**1,106**	**18,845**	-	6,012	7,822	58	13,892
Loans and receivables	**313**	**-**	**-**	**208**	**521**	-	-	-	-	-
	380	**7,642**	**10,040**	**5,211**	**23,273**	321	6,012	7,822	9,215	23,370
Carrying values		**-**								
Held-for-trading	**30**	**-**	**-**	**4,839**	**4,889**	324	-	-	9,429	9,753
Available-for-sale	**57**	**7,642**	**10,040**	**1,106**	**18,845**	-	6,012	7,822	58	13,892
Loans and receivables	**352**	**-**	**-**	**208**	**560**	-	-	-	-	-
	439	**7,642**	**10,040**	**6,153**	**24,274**	324	6,012	7,822	9,486	23,645
Of which originated in:										
- 2004 and earlier	**48**	**417**	**702**	**954**	**2,121**	81	367	576	1,396	2.420
- 2005	**17**	**1,165**	**2,993**	**1,090**	**5,265**	33	1,117	2,160	1,946	5,257
- 2006	**148**	**2,059**	**4,466**	**2,466**	**9,139**	63	1,780	3,801	3,897	9,541
- 2007 and later	**226**	**4,000**	**1,879**	**1,643**	**7,748**	147	2,748	1,284	2,248	6,427
	439	**7,642**	**10,040**	**6,153**	**24,275**	324	6,012	7,822	9,487	23,645

Notes
(1) Guaranteed by the Dutch government
(2) Covered bonds referencing primarily Dutch and Spanish mortgages

The Group's largest concentration of RMBS assets relate to a portfolio of US agency asset backed securities comprising mainly of current year vintage positions of £33.4 billion at 31 December 2008 (2007: £26.0 billion). Due to the US government backing implicit in these securities, the counterparty credit risk exposure is low. Financial markets and economic conditions have been extremely difficult in the US throughout 2008, particularly in the last quarter. Credit conditions have deteriorated and financial markets have experienced widespread illiquidity and elevated levels of volatility due to forced de-leveraging. Transaction activity in the securities portfolio has been reduced due to general market illiquidity. Residential mortgages have been affected by the stress that consumers experienced from depreciating house prices, rising unemployment and tighter credit conditions, resulting in higher levels of delinquencies and foreclosures. In particular, the deteriorating economy and financial markets have negatively impacted the valuation, liquidity, and credit quality of private-label securities.

Citizens maintains an available-for-sale investment securities portfolio to provide high-quality collateral to support cost-advantaged deposits, to provide a liquidity buffer, and to enhance earnings. The size of the portfolio has been relatively stable through 2008, but both the absolute and relative size (% of earning assets) declined in 2006-2007. The portfolio comprises high credit quality mortgage-backed securities, to ensure both pledgeability and liquidity. The U.S. Government guarantees on MBS, whether explicit or implicit, put most of the portfolio in a secure credit position. The non-agency MBS holdings derive credit support in two ways. Firstly, there is senior and subordinated structuring, and Citizens hold only the most senior tranches. Secondly, there is high quality supporting loan collateral. The collateral quality is evidenced (a) by the vintages, with 82% issued in 2005 and earlier, (b) by the borrower's weighted loan to value (LTV) ratio of 65%, and (c) by the borrower's weighted-average FICO score of 734.

A further £10.0 billion (2007: £7.8 billion) of the RMBS exposure consists of available-for-sale portfolio of European RMBS, referencing primarily Dutch and Spanish government-backed loans, and accordingly the quality of these assets has held up relative to other RMBS types.

The Group has other portfolios of RMBS from secondary trading activities, warehoused positions previously acquired with the intention of further securitisation and a portfolio of assets from the unwinding of a securities arbitrage conduit. This conduit was established to benefit from the margin between the assets purchased and the notes issued. The majority of these held-for trading-RMBS have been grouped together for management purposes.

Some of these assets (£7.0 billion) were reclassified from held-for-trading category to the loans and receivables (£1.8 billion) and available-for-sale categories during the year (£5.2 billion).

Overall, the Group has recognised significant fair value losses on RMBS assets during the year due to reduced market liquidity and deteriorating credit ratings of these assets. The Group has reduced its exposure to RMBS predominantly through fair value hedges and asset sales during the year. These decreases in were partially offset by the weakening of sterling relative to US$ and €.

3.3 Commercial mortgage-backed securities

Commercial mortgages backed securities ('CMBS') are securities that are secured by mortgage loans on commercial land and buildings. The securities are structured in the same way as an RMBS but typically the underlying assets referenced will be of greater individual value. The performance of the securities are highly dependent upon the sector of commercial property referenced and the geographical region.

The Group accumulated CMBS for the purpose of securitisation and secondary trading. The largest holding of CMBS arose as a result of the Group's purchase of senior tranches in mezzanine and high grade CMBS structures from third parties. These securities are predominantly hedged with monoline insurers. As a result, the Group's risk is limited to the counterparty credit risk exposure to the hedge. The Group also holds CMBS arising from securitisations of European commercial mortgages originated by the Group.

The following table shows the composition of the Groups holdings of CMBS portfolios.

	31 December 2008 US	UK	Europe	ROW(1)	Total	31 December 2007 US	UK	Europe	ROW(1)	Total
	£m	**£m**	**£m**	**£m**	**£m**	£m	£m	£m	£m	£m
Office	**435**	**938**	**402**	**-**	**1,775**	599	534	-	-	1,133
Mixed use	**32**	**106**	**1,048**	**45**	**1,231**	-	73	192	-	265
Healthcare	**805**	**143**	**-**	**-**	**948**	1,210	-	-	-	1,210
Retail	**295**	**43**	**17**	**48**	**403**	398	13	-	-	411
Industry	**24**	**13**	**81**	**-**	**118**	61	-	-	100	161
Multi-family	**40**	**-**	**49**	**-**	**89**	48	-	-	-	48
Leisure	**-**	**76**	**-**	**-**	**76**	-	-	-	-	-
Hotel	**40**	**35**	**-**	**-**	**75**	36	-	-	-	36
Other	**474**	**41**	**49**	**48**	**612**	931	530	765	64	2,293
	2,145	**1,395**	**1,646**	**141**	**5,327**	3,284	1,153	957	164	5,555

(1) Rest of the world

3.4 Asset-backed collateralised debt and loan obligations

Collateralised debt obligations (CDOs) are securities whose performance is dependant on a portfolio of referenced underlying securitised assets. The referenced assets generally consist of ABS, but may also include other classes of assets. Collateralised loan obligations represent securities in special purpose entities (SPEs), the assets of which are primarily cash flows from underlying leveraged loans.

The Group's ABS CDO and CLO net exposures comprised:

	2008	2007
	£m	£m
Super senior CDOs	**1,375**	3,834
Other CDOs	**1,465**	1,569
CLOs	**3,443**	4,082
	6,283	9,485

The Group's CDO exposures comprise CDOs structured by the Group from 2003 to 2007 that were unable to be sold to third parties due to prevailing illiquid markets with net exposures of £1.4 billion (2007: £3.8 billion), as well as CDO net exposures of £1.5 billion (2007:£1.6 billion) purchased from third parties some of which are fully hedged through CDS with other banks or monoline insurers.

Super senior CDOs

Super senior CDOs represent the most senior positions in a CDO, having subordination instruments (usually represented by a combination of equity, mezzanine and senior notes) which absorb losses before the super senior note is affected. Losses will only be suffered by the super senior note holders after a certain threshold of defaults of the underlying reference assets has been reached. The threshold is usually referred to in percentage terms of defaults of the remaining pool, and known as the 'attachment point'. These super senior instruments carry an AAA rating at point of origination or are senior to other AAA rated notes in the same structure. The level of defaults occurring on recent vintage sub-prime mortgages and other asset classes has been higher than originally expected. This has meant that the subordinate positions have diminished significantly in value, credit quality and rating and, as a result, the super senior tranches of the CDOs have a higher probability of suffering losses than at origination. The ratings of the majority of the underlying collateral are now below investment grade.

Depending on the quality of the underlying reference assets at issuance, the super senior tranches will be either classified as high grade or mezzanine. The majority of the Group's total exposure relates to high grade super senior tranches of ABS CDOs. The table below summarises the carrying amounts and net exposures after hedge protection of the Group's super senior CDOs as at 31 December 2008. The collateral rating is determined with reference to S&P ratings where available. Where S&P ratings are not available the lower of Moody's and Fitch ratings have been used.

	31 December 2008(1)			31 December 2007		
	High grade	**Mezzanine**	**Total**	High grade	Mezzanine	Total
	£m	**£m**	**£m**	£m	£m	£m
Gross exposure	**7,673**	**3,720**	**11,393**	6,420	3,040	9,460
Hedges and protection	(3,423)	(691)	(4,114)	(3,347)	(1,250)	(4,597)
	4,250	3,029	7,279	3,073	1,790	4,863
Write downs on net open position	(3,019)	(2.885)	(5,904)	(492)	(537)	(1,029)
Net exposure after hedges	1,231	144	1,375	2,581	1,253	3,834
	%	**%**	**%**	%	%	%
Average price	**29**	**6**	**21**	84	70	79
Underlying RMBS sub-prime assets (origination)	**69**	**91**	**79**	69	91	79
Of which originated in:						
2005 and earlier	**24**	**23**	**24**	24	23	24
2006	**28**	**69**	**46**	28	69	46
2007	**48**	**8**	**30**	48	8	30
Collateral by rating(2) at reporting date :						
AAA	**14**	**-**	**9**	36	-	23
BBB- and above	**35**	**5**	**24**	62	31	51
Non-investment grade	**51**	**95**	**67**	2	69	26
Attachment point (3)	**29**	**46**	**36**	29	46	35
Attachment point post write down	**77**	**97**	**86**	40	62	50

Notes
(1) The above table contains data for two trades liquidated in the last quarter of 2008. The data for these two trades is reported above to provide consistency with comparatives.
(2) Credit ratings are based on those from rating agencies Standard & Poor's (S&P), Moody's and Fitch and have been mapped onto S&P scale
(3) Attachment point is the minimum level of losses in a portfolio which a tranche is exposed to, as a percentage, of the total notional size of the portfolio. For example, a 5 – 10% tranche has an attachment point of 5% and a detachment point of 10%. When the accumulated loss of the reference pool is less than 5% of the total initial notional of the pool, the tranche will not be affected. However, when the loss has exceeded 5%, any further losses will be deducted from the tranche's notional principal until detachment point, 10%, is reached.

The change in net exposure during the year is analysed in the table below.

	High grade	Mezzanine	Total
		£m	£m
Net exposure at 1 January 2008	**2,581**	**1,253**	**3,834**
Net income statement	**(1,836)**	**(1,140)**	**(2,976)**
Foreign exchange and other movements	**486**	**31**	**517**
Net exposure at 31 December 2008	**1,231**	**144**	**1,375**

High grade super senior exposures

As shown in the table below, the majority of the Group's high grade super senior exposures represent securities retained in CDO structures originated by the Group.

	Gross exposures £m
Group originated deals	6,776
Third-party structures	897
Total	7,673

At origination, the reference assets of the high grade structures predominantly comprised investment grade tranches of sub-prime residential mortgage securitisations along with other senior tranches of some combination of other ABS assets, including Prime and Alt-A RMBS, CMBS, trust preferred ABS, student loan backed ABS and CDO assets. The underlying assets referenced by these super senior securities are primarily more recent vintages (the year the underlying loan was originated), with 48% being 2007. Generally, loans with more recent vintages carry greater discounts, reflecting the market expectation of greater default levels than on earlier loan vintages.

The fair value of these assets has fallen significantly during the period, representing the decline in performance in the underlying reference assets and the lack of an active market for the securities. Some of the Group's holdings (£3.4 billion) have been hedged with monoline counterparties. These exposures are detailed in section 4.

Mezzanine super senior CDOs

The mezzanine super senior tranches of CDOs have suffered a greater level of price decline than high grade tranches, due to the relative credit quality of the underlying assets. As shown in the table below, the majority of the Group's mezzanine super senior exposures represent securities retained in CDO structures originated by the Group.

	Gross exposures £m
Group originated deals	3,565
Third-party structures	155
Total	3,720

Other CDOs

The net exposure of the Group's other senior CDO exposures was £1.5 billion after hedge protection with bank or monoline counterparties. The unhedged exposures comprise CDOs representing smaller positions with various types of underlying collateral, rating and vintage characteristics.
The positions hedged with derivative protection from banks include a number of positions referencing early vintages of RMBS and other ABS assets against which it purchased protection from bank counterparties through CDS. The Group therefore has no net exposure to these certain CDOs before credit valuation adjustment. Due to the early vintage, the assets underlying these structures have not deteriorated to the same degree as the more recently issued securities. The protection purchased is from banks as opposed to monoline insurers and the credit valuation adjustment on banks is less than on monoline insurers.

Additionally, the Group has one exposure that, while not structured as a super senior security, incorporates similar risk characteristics. The exposure results from options sold to a third-party conduit structure on a portfolio of ABS. The Group assumes the risk of these securities only after the first loss protection has been eroded. The Group also has protection purchased against the remainder of this exposure through a CDS purchased from a monoline insurer.

The Group holds other subordinated note positions in CDO vehicles which have experienced significant reductions in value since inception. The majority of these positions are junior notes that have been fully written down by the Group with no ongoing exposure remaining at the balance sheet date.

CLOs

Collateralised loan obligations represent securities in special purpose entities (SPEs), the assets of which are primarily cash flows from underlying leveraged loans.

The Group has CLO exposures resulting from a number of trading activities. They consist of exposures retained by the Group and from notes purchased from third-party structures. The Group holds super senior securities in two CLO structures which were originated by the Group in 2005 and 2007. The underlying collateral of these structures predominantly references leveraged loans.

£2.3 billion of these assets were reclassified from the held-for-trading category to the loans and receivables (£0.8 billion) and available-for-sale categories during the year (£1.5 billion).

3.5 Other asset backed securities

Other assets backed securities are securities issued from securitisation vehicles, similar to those in RMBS and CMBS structures, which reference cash flow generating assets other than mortgages. The wide variety of referenced underlying assets result in diverse asset performance levels.

The Group has accumulated these assets from a range of trading and funding activities. The carrying value of the Group's other asset-backed securities by underlying asset type and geographical region are shown below.

	31 December 2008					31 December 2007				
	US	**UK**	**Europe**	**ROW**	**Total**	US	UK	Europe	ROW	Total
	£m	**£m**	**£m**	**£m**	**£m**	£m	£m	£m	£m	£m
Covered bonds	**-**	**-**	**3,301**	**-**	**3,301**	-	-	2,895	-	2,895
Auto	**97**	**29**	**466**	**13**	**606**	156	36	108	13	313
Equipment	**15**	**-**	**-**	**16**	**31**	60	20	20	7	107
Other consumer	**956**	**428**	**118**	**729**	**2,230**	384	17	56	6	464
Utilities and energy	**47**	**19**	**48**	**143**	**257**	99	35	34	13	182
Aircraft leases	**459**	**24**	**-**	**273**	**755**	287	36	36	141	501
Other leases	**1**	**525**	**455**	**-**	**980**	378	135	133	50	695
Trade receivables	**15**	**8**	**-**	**-**	**24**	68	24	24	9	126
Film / entertainment	**134**	**-**	**-**	**-**	**135**	84	30	29	11	154
Student loans	**953**	**-**	**-**	**-**	**953**	629	32	32	12	705
Other	**906**	**587**	**710**	**264**	**2,468**	2,796	1,014	1,200	337	5,347
	3,581	**1,621**	**5,098**	**1,437**	**11,738**	4,942	1,379	4,567	601	11,487

The covered bonds comprise asset-backed securities issued by several Spanish financial institutions. These securities benefit from additional credit enhancement provided by the issuing institutions. The other major asset types that increased since 2007 include other consumer loans by £1.8 billion, leases by £0.5 billion and student loans by £0.2 billion. These increases were driven by the weakening of sterling against US$ and €.

3.6 Other mortgage-related exposures

The Group's whole loans and warehouse facilities collateralised by mortgages are analysed below. These facilities primarily relate to UK and European mortgages with US mortgages representing £260 million of whole loans, of which more than 75% comprised prime mortgages.

	31 December 2008		31 December 2007	
	Whole loans	**Warehouse facilities**	Whole loans	Warehouse facilities
		£m	£m	£m
Prime	**1,905**	**1,731**	453	575
Commercial	**1,262**	**409**	2,200	900
Non-conforming	**1,396**	**1,019**	57	1,445
Sub-prime	**27**	**-**	97	-
	4,590	**3,159**	2,807	2,920

4. Counterparty valuation adjustments

4.1 Credit valuation adjustments

Credit valuation adjustments ('CVAs') 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. During 2008, as credit spreads have widened, there has been a significant increase in the CVA as set out in the table below.

	Section	**31 December 2008**	31 December 2007
		£m	£m
Monoline insurers	**4.2**	**5,988**	862
CDPCs	**4.3**	**1,311**	44
Other counterparties		**1,738**	263
Total CVA adjustments		**9,037**	1,169

The widening of credit spreads of corporate and financial institution counterparties during the year contributed to a significant increase in the level of CVA adjustments recorded across all counterparties particularly , monoline insurers and credit derivative product companies ('CDPCs').

The monoline insurer CVA is calculated on a trade-by-trade basis, and is derived using market observable monoline credit spreads. The majority of the monoline CVA is taken against credit derivatives hedging exposures to ABS. The CDPC CVA is calculated using a similar approach. However, in the absence of market observable credit spreads, the cost of hedging the counterparty risk is estimated by analysing the underlying trades and the cost of hedging expected default losses in excess of the capital available in each vehicle.

The CVA for all other counterparties, including in respect of derivatives with banks, is calculated either on a trade-by-trade basis, reflecting the estimated cost of hedging the risk through credit derivatives, or on a portfolio basis reflecting an estimate of the amount a third party would charge to assume the risk

4.2 Monoline insurers

The Group has purchased protection from monoline insurers, mainly against specific ABS, CDOs and CLOs. Monoline insurers are entities which specialise in providing credit protection against the notional and interest cash flows due to the holders of debt instruments in the event of default by the debt security counterparty. This protection is typically held in the form of derivatives such as credit default swaps ('CDS') referencing the underlying exposures held by the Group.

During the year the market value of securities protected by monoline insurers continued to decline as markets deteriorated. As the fair value of the protected assets declined, the fair value of the CDS protection from monoline insurers increased. As the monoline insurers had concentrated their exposures to credit market risks, their perceived credit quality deteriorated as concerns increased regarding their ability to meet their contractual obligations. This resulted in increased levels of CVA being recorded on the purchased protection.

The change in the Group's exposure to monoline insurers during the year has been driven by the increased value of purchased derivative protection and the strengthening of the US$ against sterling as significantly all of the exposures are US$ denominated. The combination of greater exposure and widening credit spreads has increased the level of CVA required. Towards the end of the year the Group reached settlement on a group of contracts with one monoline counterparty, thereby reducing the overall exposure.

The tables below analyse the Group's holdings of CDS with monoline counterparties.

	31 December 2008	31 December 2007
	£m	£m
Gross exposure to monolines	**11,581**	3,409
Hedges with bank counterparties	**(789)**	-
Credit valuation adjustment	**(5,988)**	(862)
Net exposure to monolines	**4,804**	2,547

The change in CVA is analysed in the table below:

	£m
At 1 January 2008	**862**
CVA realised during 2008	**(1,737)**
Net benefit on counterparty hedges	**304**
Foreign currency movement	**1,086**
Net benefit on reclassified debt securities	**1,917**
Net income statement effect	**3,556**
Balance at 31 December 2008	**5,988**

	31 December 2008				31 December 2007			
	Notional amount: protected assets £m	**Fair value: protected assets £m**	**Gross exposure £m**	**Credit valuation adjustment £m**	Notional amount: protected assets £m	Fair value: protected assets £m	Gross exposure £m	Credit valuation adjustment £m
AAA / AA rated								
CDO of RMBS	**-**	**-**	**-**	**-**	4,976	3,006	1,970	150
RMBS	**3**	**2**	**1**	**-**	73	73	-	-
CMBS	**613**	**496**	**117**	**51**	3,731	3,421	310	34
CLOs	**6,506**	**4,882**	**1,624**	**718**	9,941	9,702	239	44
Other ABS	**1,548**	**990**	**558**	**251**	4,553	4,388	165	14
Other	**267**	**167**	**100**	**47**	622	516	106	1
	8,937	**6,537**	**2,400**	**1,067**	23,896	21,106	2,790	243
A / BBB rated								
CDO of RMBS	**5,385**	**1,363**	**4,022**	**1,938**	-	-	-	-
RMBS	**90**	**63**	**27**	**10**	-	-	-	-
CMBS	**4,236**	**1,892**	**2,344**	**1,378**	-	-	-	-
CLOs	**6,009**	**4,523**	**1,486**	**778**	-	-	-	-
Other ABS	**910**	**433**	**477**	**243**	-	-	-	-
Other	**265**	**122**	**143**	**79**	-	-	-	-
	16,895	**8.396**	**8,499**	**4,426**	-	-	-	-
Sub-investment grade								
CDO of RMBS	**394**	**32**	**362**	**263**	918	453	465	465
RMBS	**-**	**-**	**-**	**-**	-	-	-	-
CMBS	**-**	**-**	**-**	**-**	-	-	-	-
CLOs	**350**	**268**	**82**	**60**	-	-	-	-
Other ABS	**1,208**	**1,037**	**171**	**123**	-	-	-	-
Other	**237**	**169**	**68**	**49**	154	-	154	154
	2,189	**1,506**	**683**	**495**	1,072	453	619	619
Total								
CDO of RMBS	**5,778**	**1,395**	**4,383**	**2,201**	5,894	3,459	2,435	615
RMBS	**93**	**65**	**28**	**10**	73	73	-	-
CMBS	**4,849**	**2,388**	**2,461**	**1,429**	3,731	3,421	310	34
CLOs	**12,865**	**9,673**	**3,192**	**1,557**	9,941	9,702	239	44
Other ABS	**3,666**	**2,460**	**1,206**	**616**	4,553	4,388	165	14
Other	**769**	**458**	**311**	**176**	776	516	260	155
	28,020	**16,439**	**11,581**	**5,989**	24,968	21,559	3,409	862

The Group also has indirect exposure through wrapped securities and assets which have an intrinsic credit enhancement from a monoline insurer. These securities are traded with the benefit of this credit enhancement and therefore any deterioration in the credit rating of the monoline is reflected in the fair value of these assets.

4.3 Credit derivative product companies

CDPCs are companies that sell protection on credit derivatives, that initially had AAA credit rating, based on models for capital allocation agreed with the rating agencies. CDPCs are similar to monoline insurers. However, unlike monoline insurers, they are not regulated as insurers.

The Group has £4.8 billion of exposures with CDPCs mainly relating to correlation trading activity. Correlation trading transactions are primarily driven by counterparties seeking credit exposure to specific baskets of underlying assets. The bespoke protection purchased from these counterparties by the Group are single name and index CDSs. As CDS spreads have widened and, credit protection has become more valuable during the year, the gross exposure to CDPC counterparties has increased.

The credit quality of CDPC counterparties has declined during the year, reflecting the negative impact of credit risk concentrations in a declining market. As a result CVA adjustments to fair value taken against these derivatives have increased significantly.

The tables below present a comparison of the protected assets and the fair value and CVA of the CDPC protection.

	31 December 2008	31 December 2007
	£m	£m
Gross exposure to CDPCs	**4,776**	863
Credit valuation adjustment	**(1,311)**	(44)
Net exposure to CDPCs	**3,465**	819

	31 December 2008				31 December 2007			
	Notional amount: protected assets £m	**Fair value: protected reference assets £m**	**Gross exposure £m**	**Credit valuation adjustment £m**	Notional amount: protected assets	Fair value: protected reference assets £m	Gross exposure £m	Credit valuation adjustment £m
AAA / AA rated	**19,092**	**15,466**	**3,626**	**908**	20,605	19,742	863	44
A / BBB rated	**6,147**	**4,997**	**1,150**	**403**	-	-	-	-
	25,239	**20,463**	**4,776**	**1,311**	20,605	19,742	863	44

Significant proportion of the gross exposure at 31 December 2008 comprises CDS tranches with 16% - 53% attachment-detachment points for those hedged by AAA / AA CDPCs and 16% - 38% for those hedged by lower rated CDPCs. The underlying assets are principally investment grade.

The year on year movement in the CDPC CVA is analysed below:

	£m
At 1 January 2008	**44**
Net benefit on CVA hedges	**533**
Foreign currency movement	**119**
Net income statement effect	**615**
Balance at 31 December 2008	**1,311**

5. Leveraged finance

Leveraged finance is commonly employed to facilitate corporate finance transactions, such as acquisitions or buy-outs. A bank acting as a lead manager will typically underwrite the loan, alone or with others, and then syndicate the loan to other participants.

The Group's syndicated loan book represent amounts retained from underwriting positions where the Group was lead manager or underwriter, in excess of the Group's intended long term participation.

Since the beginning of the credit market dislocation in the second half of 2007, investor appetite for leveraged loans and similar risky assets has fallen dramatically, with secondary prices falling due to selling pressure and margins increasing, thus also affecting the primary market. There were a small number of deals executed in the first half of 2008 which were much less significant in overall quantum and leverage and which were priced at less than mid-2007 levels. Concerted efforts to sell positions during the first half of 2008 were only partially successful due to the rapid change in market conditions since origination of the loans. Most of the leveraged finance loans were reclassified from the held-for-trading category to loans and receivables category in the second half of 2008 (see section 6.)

The table below shows the carrying value of leveraged finance exposures by industry and geography.

	31 December 2008					31 December 2007				
	Americas	**UK**	**Europe**	**ROW**	**Total**	Americas	UK	Europe	ROW	Total
	£m	**£m**	**£m**	**£m**	**£m**	£m	£m	£m	£m	£m
TMT	**1,681**	**628**	**402**	**45**	**2,756**	6,924	424	482	25	7,855
Retail	**166**	**550**	**707**	**21**	**1,444**	542	1,318	800	49	2,709
Industrial	**280**	**391**	**413**	**-**	**1,084**	249	2,003	1,074	44	3,370
Other	**11**	**552**	**141**	**35**	**739**	25	339	271	13	648
	2,138	**2,121**	**1,663**	**101**	**6,023**	7,740	4,084	2,627	131	14,582
Of which:										
Held-for-trading	**31**	**31**	**41**	**-**	**103**	7,607	3,694	689	51	12,041
Loans and receivables	**2,107**	**2,090**	**1,622**	**101**	**5,920**	133	390	1,938	80	2,541
	2,138	**2,121**	**1,663**	**101**	**6,023**	7,740	4,084	2,627	131	14,582
Of which:										
Drawn	**2,081**	**2,090**	**1,453**	**94**	**5,718**	2,249	4,025	2,478	122	8,874
Undrawn	**57**	**31**	**210**	**7**	**305**	5,491	59	149	9	5,708
	2,138	**2,121**	**1,663**	**101**	**6,023**	7,740	4,084	2,627	131	14,582

Note: Leveraged finance as disclosed above for 31 December 2007 has been aligned with definitions used in 2008 in terms of industry classification and is additionally £76 million higher than previously published.

The table below analyses the amounts reported above

	Held-for-trading			**Loans and receivables**		
	Drawn	**Undrawn**	**Total**	**Drawn**	**Undrawn**	**Total**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**
Balance at 1 January 2008	**6,516**	**5,525**	**12,041**	**2,358**	**183**	**2,541**
Reclassifications	**(3,602)**	**-**	**(3,602)**	**3,602**	**-**	**3,602**
Reclassifications – income effect	**216**	**-**	**216**	**19**	**-**	**19**
Additions	**1,171**	**682**	**1,853**	**235**	**-**	**235**
Sales	**(3,826)**	**(1,882)**	**(5,708)**	**(473)**	**(81)**	**(554)**
Realised losses on sale	**(298)**	**-**	**(298)**	**(197)**	**-**	**(197)**
Funded deals	**1,298**	**(1,298)**	**-**	**-**	**-**	**-**
Lapsed / collapsed deals	**(415)**	**(3,738)**	**(4,153)**	**(173)**	**-**	**(173)**
Changes in fair value	**(462)**	**(156)**	**(618)**	**N/A**	**N/A**	**N/A**
Impairment provisions	**N/A**	**N/A**	**N/A**	**(1,191)**	**-**	**(1,191)**
Exchange and other movements	**211**	**161**	**372**	**1,603**	**35**	**1,638**
Presentation changes	**(778)**	**778**	**-**	**(96)**	**96**	**-**
Balance at 31 December 2008	**31**	**72**	**103**	**5,687**	**233**	**5,920**

N/A not applicable

In addition to the leveraged finance syndicated portfolio discussed above, the Group has £7 billion of portfolio positions, mostly to European companies, that have been classified as loans and receivables since origination.

6. Reclassification of financial instruments

In October 2008, the IASB issued and, the European Union endorsed, amendments to IAS 39 'Financial Instruments: Recognition and Measurement' (IAS 39) to permit the reclassification of financial assets out of the held-for-trading (HFT) and available-for-sale (AFS) categories. Transfers must be made at fair value and this fair value becomes the instruments' new cost or amortised cost. The amendments are effective from 1 July 2008. Reclassifications made before 1 November 2008 were backdated to 1 July 2008; subsequent reclassifications were effective from the date the reclassification was made.

During 2008 the Group reclassified financial assets from the held-for-trading and available-for-sale categories into the loans and receivables 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 balance sheet values of these assets, the effect of the reclassification on the income statement for the period from the date of reclassification to 31 December 2008 and the gains / losses relating to these assets recorded in the income statement for the years ended 31 December 2008 and 2007:

			31 December 2008		2008					2007
	On reclassification					After reclassification				
	Carrying value	Expected cash flows	Carrying value	Fair value	Gains/ (losses) - to the date of reclassification	Income	Impairment losses	Gains/ losses in AFS reserve	Amount that would have been recognised	Gains / (losses) recognised in the income statement in prior periods
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Reclassified from HFT to LAR:										
<u>Loans</u>										
Leveraged finance	**3,602**	**6,083**	**4,304**	**2,523**	**(457)**	**454**	**-**	**N/A**	**(1,206)**	(155)
Corporate loans	**5,040**	**7,582**	**5,827**	**4,940**	**(76)**	**198**	**-**	**N/A**	**(681)**	(50)
	8,642	**13,665**	**10,131**	**7,463**	**(533)**	**652**	**-**	**N/A**	**(1,887)**	(205)
<u>Debt securities</u>										
CDO of RMBS	**215**	**259**	**236**	**221**	**4**	**5**	**-**	**N/A**	**(11)**	5
RMBS	**1,765**	**2,136**	**2,011**	**1,536**	**(115)**	**157**	**-**	**N/A**	**(302)**	(12)
CMBS	**1**	**4**	**1**	**1**	**1**	**-**	**-**	**N/A**	**-**	-
CLOs	**835**	**1,141**	**952**	**717**	**(22)**	**104**	**-**	**N/A**	**(130)**	(14)
Other ABS	**2,203**	**3,202**	**2,514**	**2,028**	**(67)**	**129**	**-**	**N/A**	**(338)**	3
Other	**2,538**	**2,764**	**2,602**	**2,388**	**72**	**3**	**-**	**N/A**	**(166)**	94

	7,557	**9,506**	**8,316**	**6,891**	**(127)**	**398**	**-**	**N/A**	**(947)**	76
Total	**16,199**	**23,171**	**18,447**	**14,354**	**(660)**	**1,050**	**-**		**(2,834)**	(129)
Reclassified from HFT to AFS:										
Debt securities:										
CDO of RMBS	**6,228**	**8,822**	**5,695**	**5,695**	**(1,330)**	**1,147**	**(464)**	**(1,069)**	**(280)**	(400)
RMBS	**5,205**	**8,890**	**5,171**	**5,171**	**(530)**	**24**	**-**	**(162)**	**(122)**	(4)
CMBS	**32**	**85**	**31**	**31**	**(5)**	**5**	**-**	**(3)**	**2**	(4)
CLOs	**1,457**	**1,804**	**1,288**	**1,288**	**(168)**	**421**	**-**	**(383)**	**58**	(36)
Other ABS	**2,199**	**3,183**	**1,847**	**1,847**	**(356)**	**(10)**	**-**	**(354)**	**(311)**	(42)
Other	**614**	**1,311**	**698**	**698**	**-**	**130**	**-**	**(166)**	**(5)**	(1)
	15,735	**24,095**	**14,730**	**14,730**	**(2,389)**	**1,717**	**(464)**	**(2,137)**	**(658)**	(487)
Reclassified from AFS to LAR:										
Debt securities	**704**	**772**	**1,028**	**968**	**(12)***	**6**	**-**	**-**	**(37)***	-
Total	**704**	**772**	**1,028**	**968**	**(12)**	**6**	**-**	**-**	**(37)**	-
Total	**32,638**	**48,038**	**34,205**	**30,052**	**(3,061)**	**2,773**	**(464)**	**(2,137)**	**(3,529)**	(616)

* Losses recognised in the AFS reserve.

7. Valuation of financial instruments

7.1 Control environment

The Group's control environment for the determination of the fair value of financial instruments has been designed to ensure there are formalised review protocols for independent review and validation of fair values separate from those businesses entering into the transactions. This includes specific controls to ensure consistent pricing policies and procedures, incorporating disciplined price verification for both proprietary and counterparty risk trades. The Group ensures special attention is given to bespoke transactions, structured products, illiquid products, and other assets which are difficult to price.

The business entering into the transaction is responsible for the initial determination and recording of the fair value of the transaction. There are daily controls over the profit or loss recorded by trading and treasury front office traders.

A key element of the control environment, segregated from the recording of the transaction's valuation, is the independent price verification (IPV) process. Valuations are first calculated by the business which entered into the transaction. Such valuations may be direct prices, or may be derived using a model and variable model inputs. These valuations are reviewed, and if necessary amended, by the IPV process. This process involves a team independent of those trading the financial instruments performing a review of valuations in the light of available pricing evidence. IPV is performed at a frequency to match the availability of independent data, and the size of the Group's exposure. For liquid instruments the process is performed daily. The minimum frequency of review is monthly for Regulatory Trading Book positions, and six monthly for Regulatory Banking book positions. The IPV control includes formalised reporting and escalation of any valuation differences in breach of defined thresholds. In addition, within GBM, there is a dedicated team (the Global Pricing Unit) which determines IPV Policy, monitors adherence to policy, and performs additional independent review on highly subjective valuation issues.

When models are used to value products, those models are subject to the Modelled Products Review process. This process requires different levels of model documentation, testing and review, depending on the complexity of the model and the size of the Group's exposure to the model. A key element of the control environment over model use in GBM is the Modelled Product Review Committee, which comprises of valuations experts from several functions within GBM. The committee sets the policy for model documentation, testing and review, and prioritises models with significant exposure for review by the Group's Quantitative Research Centre. This Centre independent of the trading businesses, and 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 which may also be appropriate.

GBM also maintains a Valuation Control Committee that meets formally on a monthly basis to discuss and review escalated items and to consider highly complex and subjective valuation matters. The committee includes valuation specialists representing several independent review functions (including Market Risk, Quantitative Research and Finance) and meeting information is also circulated to senior members of the Group's front office trading businesses.

Certain financial instruments have become more difficult and subjective to value and have therefore been transferred to a centrally managed asset unit, in order to separate them from business as usual activities and to allow dedicated focus on the management and valuation of the exposures. The unit has a Valuation Committee comprising senior representatives of the trading function, Risk Management and the Global Pricing Unit which meets regularly and is responsible for monitoring, assessing and enhancing the adequacy of the valuation techniques being adopted for these instruments.

7.2 Valuation techniques

The Group uses a number of methodologies to determine the fair values of financial instruments for which observable prices in active markets for identical instruments are not available. These techniques include: relative value methodologies based on observable prices for similar instruments; present value approaches where future cash flows from the asset or liability are estimated and then discounted using a risk-adjusted interest rate; option pricing models (such as Black-Scholes or binomial option pricing models) and simulation models such as Monte-Carlo.

The principal inputs to these valuation techniques are listed below. Values between and beyond available data points are obtained by interpolation and extrapolation. When utilising valuation techniques, the fair value can be significantly impacted by the choice of valuation model and underlying assumptions made concerning factors such as the amounts and timing of cash flows, discount rates and credit risk.

- Bond prices – quoted prices are generally available for government bonds, certain corporate securities and some mortgage-related products.
- Credit spreads – where available, these are derived from prices of CDS or other credit based instruments, such as debt securities. For others, credit spreads are obtained from pricing services.
- Interest rates – these are principally benchmark interest rates such as the London Inter-Bank Offered Rate (LIBOR) and quoted interest rates in the swap, bond and futures markets.
- Foreign currency exchange rates – there are observable markets both for spot and forward contracts and futures in the world's major currencies.

- Equity and equity index prices – quoted prices are generally readily available for equity shares listed on the world's major stock exchanges and for major indices on such shares.
- Commodity prices – many commodities are actively traded in spot and forward contracts and futures on exchanges in London, New York and other commercial centres.
- Price volatilities and correlations – volatility is a measure of the tendency of a price to change with time. Correlation measures the degree to which two or more prices or other variables are observed to move together. If they move in the same direction there is positive correlation; if they move in opposite directions there is negative correlation. Volatility is a key input in valuing options and the valuation of certain products such as derivatives with more than one underlying variable that are correlation-dependent. Volatility and correlation values are obtained from broker quotations, pricing services or derived from option prices.
- Prepayment rates – the fair value of a financial instrument that can be prepaid by the issuer or borrower differs from that of an instrument that cannot be prepaid. In valuing prepayable instruments that are not quoted in active markets, the Group considers the value of the prepayment option.
- Counterparty credit spreads – adjustments are made to market prices (or parameters) when the creditworthiness of the counterparty differs from that of the assumed counterparty in the market price (or parameters).
- Recovery rates / loss given default - these are used as an input to valuation models and reserves for ABS and other credit products as an indicator of severity of losses on default. Recovery rates are primarily sourced from market data providers or inferred from observable credit spreads.

The Group refines and modifies its valuation techniques as markets and products develop and as the pricing for individual products becomes more or less readily available. While the Group believes its valuation techniques are appropriate and consistent with other market participants, the use of different methodologies or assumptions could result in different estimates of fair value at the balance sheet date.

In order to determine a reliable fair value, where appropriate, management applies valuation adjustments to the pricing information derived from the above sources. These adjustments reflect management's assessment of factors that market participants would consider in setting a price, to the extent that these factors have not already been included in the information from the above sources. Furthermore, on an ongoing basis, management 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, management makes adjustments to the model valuation to calibrate to other available pricing sources. Where unobservable inputs are used, management may determine a range of possible valuations based upon differing and 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 correct model valuations for any known limitations. In addition, the Group makes adjustments to defer income for financial instruments valued at inception where the valuation of that financial instrument materially depends on one or more unobservable model inputs.

7.3 Valuation hierarchy

The table below shows the financial instrument carried at fair value at 31 December 2008, by valuation method.

	31 December 2008				31 December 2007			
	Level 1[(1)]	**Level 2[(2)]**	**Level 3[(3)]**	**Total**	Level 1[(1)]	Level 2[(2)]	Level 3[(3)]	Total
	£bn	**£bn**	**£bn**	**£bn**	£bn	£bn	£bn	£bn
Assets								
Fair value through profit or loss								
Loans and advances to banks	**-**	**56.2**	**-**	**56.2**	-	71.5	0.1	71.6
Loans and advances to customers	**-**	**50.5**	**3.1**	**53.6**	-	94.4	13.1	107.5
Debt securities	**52.8**	**65.1**	**3.8**	**121.7**	83.1	101.7	11.6	196.4
Equity shares	**10.6**	**7.8**	**0.8**	**19.2**	36.5	8.1	0.8	45.4
Derivatives	**3.9**	**978.4**	**10.3**	**992.6**	1.9	330.3	5.2	337.4
	67.3	**1,158.0**	**18.0**	**1,243.3**	121.5	606.0	30.8	758.3
Available-for-sale								
Debt securities	**21.1**	**108.7**	**3.1**	**132.9**	32.1	62.4	1.1	95.6
Equity shares	**4.8**	**2.1**	**0.3**	**7.2**	5.8	1.0	0.8	7.6
	25.9	**110.8**	**3.4**	**140.1**	37.9	63.4	1.9	103.2
	93.2	**1,268.8**	**21.4**	**1,383.4**	159.4	669.4	32.7	861.5
Liabilities								
Deposits by banks and customers	**-**	**144.8**	**0.3**	**145.1**	-	131.9	1.5	133.4
Debt securities in issue	**-**	**47.1**	**4.4**	**51.5**	-	42.1	9.2	51.3
Short positions	**36.0**	**6.5**	**-**	**42.5**	63.6	9.9	-	73.5
Derivatives	**3.6**	**963.7**	**4.0**	**971.3**	2.1	325.6	4.4	332.1
Other financial liabilities	**-**	**1.5**	**0.3**	**1.8**	-	0.9	0.2	1.1
	39.6	**1,163.6**	**9.0**	**1,212.2**	65.7	510.4	15.3	591.4

Notes

(1) Valued using unadjusted quoted prices in active markets for identical financial instruments. This category includes listed equity shares, certain exchange-traded derivatives, G10 government securities and certain US agency securities.

(2) Valued using techniques based significantly on observable market data. Instruments in this category are valued 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 valuation 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 include most government agency securities, investment-grade corporate bonds, certain mortgage products, certain bank and bridge loans, repos and reverse repos, less liquid listed equities, state and municipal obligations, most physical commodities, investment contracts issued by the Group's life assurance businesses and certain money market securities and loan commitments and most OTC derivatives.

(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, management determine a reasonable level for the input.

Financial instruments Certain included within level 3 of the fair value hierarchy 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 collateralised debt obligations (CDOs), and 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 long dated and exotic derivatives. No gain or loss is recognised on the initial recognition of a financial instrument valued using a technique incorporating significant unobservable data.

(4) Other financial liabilities comprise subordinated liabilities and write downs relating to undrawn syndicated loan facilities.

7.4 Level 3 portfolios

Level 3 loans and advances decreased by £10 billion, reflecting sales of £8 billion, reclassification (from fair value classifications to non-fair value classifications) of certain loans, primarily leveraged finance, partly offset by fair value adjustments on the remaining portfolio at the end of the year.

Debt securities categorised as level 3 at the end of the year include £4.9 billion of mortgage and asset-backed securities and £1.4 billion of corporate debt securities. The decrease during the year reflects termination of a deal (£5 billion) in early 2008 and reclassification of £4.6 billion illiquid MBS from fair value classifications to non-fair value classifications. These decreases are partly offset by fair value changes, including £1.3 billion write down of super senior CDOs, and by the transfer of certain sub-prime MBS from level 3 to level 2 due to improved price transparency at the year end date.

Level 3 derivative assets at 31 December 2008 include credit derivative trades with CDPCs with a fair value of £3.5 billion after credit valuation adjustments of £1.3 billion. At 31 December 2007 these credit derivative trades with CDPCs had a fair value of £0.8 billion after a credit valuation adjustment of £44 million and were included within level 2 of the fair value hierarchy. Other level 3 derivative assets at 31 December 2008 include illiquid CDSs, other credit derivatives, commodity derivatives and illiquid interest rate derivatives.

Debt securities in issue, categorised as level 3 were structured medium term notes and the decrease in the year primarily reflects the termination of a deal (£4.7 billion) in the first half of 2008.

The tables below presents the Level 3 financial instruments carried at fair value as at the balance sheet date, valuation basis, main assumptions used in the valuation of these instruments and reasonably possible increases or decreases in fair value based on reasonably possible alternative assumptions:

Level 3 loans and advances decreased by £10 billion, reflecting sales of £8 billion, reclassification of certain loans, primarily leveraged finance to loans and receivables (‘LAR’), partly offset by fair value adjustments on the remaining portfolio at the end of the year.

Debt securities categorised as level 3 at the end of the year include £4.9 billion of mortgage and asset-backed securities and £1.4 billion of corporate debt securities. The decrease during the year reflects termination of a deal (£5 billion) in early 2008, reclassification of £4.6 billion illiquid MBS to LAR partly offset by fair value changes, including £1.3 billion on super senior CDOs and the transfer of certain previous illiquid MBS, primarily sub-prime from level 3 to level 2.

Level 3 derivative assets at 31 December 2008 include credit derivative trades with CDPCs with a fair value of £3.5 billion after credit valuation adjustments of £1.3 billion. At 31 December 2007 these credit derivative trades with CDPCs had a fair value of £0.8 billion after a credit valuation of £44 million and were included within level 2 of the fair value hierarchy. Other level 3 derivative assets at 31 December 2008 includes illiquid CDSs, other credit derivatives, commodity derivatives and illiquid interest rate derivatives.

Debt securities in issue, categorised as level 3 were structured medium term notes and the decrease in the year primarily reflects the [early] termination of a deal (£4.7 billion) in the first half of 2008.

The tables below presents the Level 3 financial instruments carried at fair value as at the balance sheet date, valuation basis, main assumptions used in the valuation of these instruments and reasonably possible increases or decreases in fair value based on reasonably possible alternative assumptions:

Assets	**Valuation basis / technique**	**Main assumptions**	**Carrying value**	**Reasonably possible alternative assumptions**	
				Increase in fair value	**Decrease in fair value**
			£bn	**£m**	**£m**
Loans and advances	Proprietary model	Credit spreads, indices	**3.1**	**70**	**50**
Debt securities:					
- RMBS	Industry standard model	Prepayment rates, probability of default, loss severity and yield	**0.5**	**40**	**90**
- CMBS	Industry standard model	Prepayment rates, probability of default, loss severity and yield	**0.6**	**30**	**30**
- CDOs	Proprietary model	Implied collateral valuation, defaults rates, housing prices, correlation	**1.7**	**410**	**440**
- CLOs	Industry standard simulation model	Credit spreads, recovery rates, correlation	**1.0**	**40**	**40**
- Other	Proprietary model	Credit spreads	**3.1**	**50**	**50**
Derivatives:					
- credit	Proprietary CVA model, industry option models, correlation model	Counterparty credit risk, correlation, volatility	**8.0**	**1,030**	**1,200**
- equity	Proprietary model	Volatility, correlation, dividends	**0.1**	**-**	**10**
- other	Proprietary model	Volatility, correlation	**2.2**	**130**	**130**
Equity shares	Private equity - valuation statements	Fund valuations	**1.1**	**80**	**160**
31 December 2008			**21.4**	**1,880**	**2,200**
31 December 2007			32.7	610	700

Liabilities	**Valuation basis / technique**	**Main assumptions**	**Carrying value**	**Reasonably possible alternative assumptions**

			£bn	Increase in fair value £m	Decrease in fair value £m
Debt securities in issue	Proprietary model	Credit spreads	**4.4**	**170**	**190**
Derivatives					
- credit	Proprietary CVA model, industry option models, correlation model	Correlation, volatility	**2.6**	**160**	**180**
- Other	Proprietary model	Volatility, correlation	**1.4**	**120**	**120**
Other portfolios	Proprietary model	Credit spreads, correlation	**0.6**	**40**	**60**
31 December 2008			**9.0**	**490**	**550**
31 December 2007			15.3	120	120

For each of the portfolio categories shown in the above table, set out below is a description of the types of products that comprise the portfolio and the valuation techniques that are applied in determining fair value, including a description of models used and inputs to those models. 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 along with the impact this would have on the fair value. Where there have been significant changes to valuation techniques during the year a discussion of the reasons for this is also included.

Loans and advances to customers

Loans in level 3 primarily comprise US commercial mortgages and syndicated loans.

Commercial mortgages

These senior and mezzanine commercial mortgages are loans secured on commercial land and buildings that were originated or acquired by GBM 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. Using reasonably possible alternative assumptions for credit spreads (taking into account all other applicable factors) would reduce the fair value of these mortgages of £1.1 billion by up to £18 million or increase the fair value by up to £25 million.

Syndicated lending

The Group's syndicated lending activities are conducted by the syndicate business in conjunction with the various product lines covering corporate, leveraged, real estate and project finance activities. When a commitment to lend is entered into, the Group estimates the proportion of the loan that is intended to be held for trading on draw down, and the proportion it anticipates to retain on its balance sheet as a loan and receivable. Where the commitment is intended to be syndicated, the commitment to lend is marked to market through the income statement. On draw down, the portion of the loan expected to be syndicated is recorded at fair value through profit or loss as a held for trading asset, and the expected hold portion is measured at amortised cost less, where appropriate, impairment.

The Group values the portion of the loan expected to be syndicated at fair value by using market observable syndication prices in the same or similar assets. Where these prices are not available, a discounted cash flow model is used. The model incorporates observable assumptions such as current interest rates and yield curves, the notional and tender amount of the loan and counterparty credit quality where it is derived from credit default swap spreads using market indices. The model also incorporates unobservable assumptions, including expected refinancing periods, and counterparty credit quality where it is derived from the Group's internal risk assessments. Derivatives arising from commitments to lend are measured using the same model, based on proxy notional amounts.

Using reasonably possible alternative assumptions for expected cash flows to value these assets of £2.0 billion would reduce the fair value by up to £32 million or increase the fair value by up to £45 million. The assumptions to determine these amounts were based on restructuring scenarios and expected margins.

Debt securities

Residential mortgage backed securities

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 market value. RMBS are classified as Level 3 when trading activity is not available and a model is utilised which incorporates significant unobservable data.

In determining whether an instrument is similar to that being valued, management 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, management 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. The 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 management, or based on observable prices from Bloomberg or consensus pricing services.

Where there is an absence of trading activity, models are used. 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 a third party pricing service, independent research, broker quotes, and other independent sources. An assessment is made of the third-party data source to determine its applicability and reliability. Management adjusts the model price with a liquidity premium to reflect the price that the instrument could be traded at in the market. Management may also make adjustments for model deficiencies.

The weighted average of the key significant inputs utilised in valuing Level 3 RMBS positions are shown in the table below.

	Non-agency prime	**Alt-A**
Yield	11.02%	20.69%
Probability of default	3.0 CDR [(1)]	40.00 CDR[(1)]
Loss severity	45.00%	52.25%
Prepayment	12.67 CPR[(2)]	10.65 CPR[(2)]

Notes:
(1) Constant default rate or probability of default
(2) Constant prepayment rate

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. Through most of 2008, while default rates on sub-prime mortgages generally increased, there was less detailed and transparent market information on defaults available which could be used to predict future defaults on both Alt-A and prime securities. As such, the Group believes that probability of default was the least transparent input into Alt-A and prime RMBS modelled valuations throughout 2008 (and most sensitive to variations). The Group believes that a range of 500 basis points greater than and 500 basis points less than the weighted average constant default rate, and a range of 200 basis points greater than and 200 basis points less than the weighted average constant default rate represents a reasonably possible set of acceptable pricing alternatives for Alt-A and prime RMBS, respectively. These assumptions consider the inherently risky nature of Alt-A over prime securities, as well as declining economic conditions leading to an increased likelihood of default at year-end. While other key inputs may possess characteristics of unobservability in both Alt-A and prime modelled valuations, the impact of utilising reasonably possible alternatives for these respective inputs would have an immaterial impact on the overall valuation. Using these reasonably possible alternative assumptions the fair value of RMBS of £0.5 billion would be £90 million lower or £40 million higher.

Commercial mortgage backed securities

CMBS are valued using an industry standard model and the inputs, where possible, are corroborated using observable market data.

For senior CMBS and subordinated tranches respectively, the Group determined that the most sensitive input to reasonably possible alternatives for unobservable inputs is probability of default and yield respectively. Using reasonably possible alternative assumptions for these inputs, the fair value of CMBS of £ 0.6 billion would be £30 million lower or £30 million higher.

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.

The Group's proprietary model calculates the expected cash flows from the underlying mortgages using assumptions derived from publicly available data on future macroeconomic conditions (including house price appreciation and depreciation) and on defaults and delinquencies on these underlying mortgages. The model used by the Group comprises an econometric loan-level model which provides the input to an industry standard ABS model, the output of which feeds a proprietary model generating expected cash flows which are discounted using a risk adjusted rate.

Due to the subjectivity of the inputs to the pricing model, alternative valuation points are constructed to benchmark the output of the model. These valuation points include determining an ABS index implied collateral valuation, which provides a market calibrated valuation data point. A collateral net asset value methodology is also considered which uses dealer buy side marks to determine an upper bound for super senior CDO valuations. Both the ABS index implied valuation and the collateral net asset value methodology apply an assumed immediate liquidation approach.

Management, using all pricing points available, may make necessary and appropriate valuation adjustments to the pricing information derived from the proprietary model. These adjustments reflect management's assessment of factors that market participants would consider in setting a price, to the extent that these factors that have not already been included in the model and may include adjustments made for liquidity discounts.

In order to provide disclosures of the valuation of super senior CDOs using reasonably possible alternative assumptions, management has considered macroeconomic conditions, including house price appreciation and depreciation, and the effect of regional variations. The output from using these alternative assumptions has been compared with inferred pricing from other published data. The Group believes that reasonably possible alternative assumptions could reduce or increase valuations by up to 4%. Using these alternative assumptions would reduce the fair value of level 3 CDOs of £1.7 billion by up to £440 million (super senior CDOs: £292 million) and increase the fair value by up to £410 million (super senior CDOs: £292 million).

Collateralised loan obligations

To determine the fair value of CLOs purchased from third parties, management 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. As the correlation inputs to this model are not observable CLOs are deemed to be level 3. Using reasonably possible alternative assumption the fair value of CLOs of £1.0 billion would be £40 million lower or £40 million higher.

Other debt securities

Other level 3 debt securities comprise £1.5 billion of other ABS and £1.6 billion of other debt securities. Where observable market prices for a particular debt security are not available, the fair value will typically be determined with reference to observable market transactions in other related products, such as similar debt securities or credit derivatives. Assumptions are made about the relationship between the individual debt security and the available benchmark data. Where significant management judgement has been applied in identifying the most relevant related product, or in determining the relationship between the related product and the instrument itself, the valuation is shown in level 3. Using differing assumptions about this relationship would result in different fair values for these assets and liabilities. The main assumption made is that of relative creditworthiness. Using reasonably possible alternative credit assumptions, taking into account the underlying currency, tenor, and rating of the debt securities within each portfolio, would reduce the fair value of other debt securities by up to £50 million or increase the fair value by up to £50 million.

Derivatives

Level 3 derivative assets are comprised of credit derivatives of £8.0 billion, equity derivatives of £0.1 billion and interest rate, foreign exchange rate and commodity derivative contracts of £2.2 billion. Derivative liabilities comprise credit derivatives of £2.6 billion, and interest rate, foreign exchange rate and commodity derivatives contracts of £1.4 billion.

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

The Group's credit derivatives include vanilla and bespoke portfolio tranches, gap risk products and certain other unique trades. The bespoke portfolio tranches are synthetic tranches referenced to a bespoke portfolio of corporate names on which the Group purchases credit protection. Bespoke portfolio tranches are valued using Gaussian Copula, a standard method which uses observable market inputs (credit spreads, index tranche prices and recovery rates) to generate an output price for the tranche via a mapping methodology. In essence this method takes the expected loss of the tranche expressed as a fraction of the expected loss of the whole underlying portfolio and calculates which detachment point on the liquid index, and hence which correlation level, coincides with this expected loss fraction. Where the inputs into this valuation technique are observable in the market, bespoke tranches are considered to be level 2 assets. Where inputs are not observable, bespoke tranches are considered to be level 3 assets. However, all transactions executed with a CDPC counterparty are considered level 3 as the counterparty credit risk assessment is a significant component of these valuations.

Gap risk products are leveraged trades, with the counterparty's potential loss capped at the amount of the initial principal invested. Gap risk is the probability that the market will move discontinuously too quickly to exit a portfolio and return the principal to the counterparty without incurring losses, should an unwind event be triggered. This optionality is embedded within these portfolio structures and is very rarely traded outright in the market. Gap risk is not observable in the markets and, as such, these structures are deemed to be level 3 instruments.

Other unique trades are valued using a specialised model for each instrument and the same market data inputs as all other trades where applicable. By their nature, the valuation is also driven by a variety of other model inputs, many of which are unobservable in the market. Where these instruments have embedded optionality it is valued using a variation of the Black-Scholes option pricing formula, and where they have correlation exposure it is valued using a variant of the Gaussian Copula model. The volatility or unique correlation inputs required to value these products are generally unobservable and the instruments are therefore deemed to be level 3 instruments.

Other derivatives

Exotic equity, interest rate and commodity options provide a payout (or series of payouts) linked to the performance of one or more underlying, including equities, interest rates, foreign exchange rates and commodities. Included in commodities derivatives are energy contracts entered into by RBS Sempra Commodities. Most of these contracts are valued using models that incorporate observable data. A small number are more complex, structured derivatives which incorporate in their valuation assumptions regarding power price volatilities and correlation between inputs, which are not market observable. These include certain tolling agreements, where power is purchased in return for a given quantity of fuel, and load deals, where a seller agrees to deliver a fixed proportion of power used by a client's utility customers.

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 equities, interest rates, foreign exchange rates and commodity prices. Correlations for more liquid equity and rate pairs are valued using independently sourced consensus pricing levels. Where a consensus pricing benchmark is unavailable, these instruments are categorised as level 3.

Reasonably possible alternative assumptions (for all derivative assets)

In determining the effect of reasonably possible alternative assumptions for unobservable inputs, the Group has considered trades with CDPCs separately from all other level 3 derivatives due to the significant element of subjectivity in determining the counterparty credit risk.

The fair value of credit derivative trades with CDPCs as at 31 December 2008 was £4.8 billion before applying a CVA of £1.3 billion. The Group's credit derivative exposures to CDPCs are valued using pricing models with inputs observed directly in the market. An adjustment is made to the model valuation as the creditworthiness of CDPC counterparties differs from that of the credit risk assumption within the valuation model. The adjustment reflects the estimated cost of hedging the counterparty risk arising from each trade. In the absence of market observable credit spreads of CDPCs, the cost of hedging the counterparty risk is estimated from an analysis of the underlying trades and the cost of hedging expected default losses in excess of the capital available in each vehicle. A reasonably possible alternative approach would be to estimate the cost of hedging the counterparty risk from market observable credit spreads of entities considered similar to CDPCs (for example monoline insurers with similar business or similarly rated entities). These reasonably possible alternative approaches would reduce the fair value credit derivatives with CDPCs by up to £740 million or increase the fair value by up to £600 million.

For all other level 3 derivatives, unobservable inputs are principally comprised of correlations and volatilities. Where a derivative valuation relies significantly on an unobservable input, the valuation is shown in level 3. It is usual for such derivative valuations to depend on several observable, and one or few unobservable model inputs. In determining reasonably possible alternative assumptions, the relative impact of unobservable inputs as compared to those which may be observed was considered. Using reasonably possible alternative assumptions the fair value of all level 3 derivatives (excluding CDPCs) of £4.0 billion would be reduced by up to £600 million or increased by up to £560 million. Using reasonably possible alternative assumptions, the fair value of all other level 3 derivatives liabilities of £4 billion would be reduced by up to £300 million or increased by up to £280 million.

Equity shares - private equity

Private equity investments include unit holdings and limited partnership interests primarily in corporate private equity funds, debt funds and fund of hedge 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.

Although such valuations are provided from third parties, the Group recognises that such valuations may rely significantly on the judgements and estimates made by those fund managers, particularly in assessing private equity components. Following the decline in liquidity in world markets, the Group believes that there is now sufficient subjectivity in such valuations to report them in level 3.

Reasonably possible alternative valuations have been determined based on the historic trends in valuations received, and by considering the possible impact of market movements towards the end of the reporting period, which may not be fully reflected in valuations received. Using these reasonably possible alternate assumptions would reduce the fair value of externally managed funds of £1.1 billion by up to £160 million or increase the fair value by up to £80 m.

Other financial instruments

Other than the portfolios discussed above, there are other financial instruments which are held at fair value determined from data which are not market observable, or incorporating material adjustments to market observed data. Using reasonably possible alternate assumptions appropriate to the financial asset or liability in question, such as credit spreads, derivative inputs and equity correlations, would reduce the fair value of other financial instruments held at fair value of £4.9 billion, primarily debt securities in issue of £4.4 billion, and included in level 3 by up to £250 million or increase the fair value by up to £210 million.

7.5 Own credit

When valuing financial liabilities recorded at fair value, the Group takes into account the effect of its own credit standing. The categories of financial liabilities on which own credit spread adjustments are made are issued debt, including issued structured notes, and derivatives. An own credit adjustment is applied to positions where it is believed that counterparties would consider the Group's creditworthiness when pricing trades.

For issued debt and structured notes, this adjustment is based on independent quotes from market participants for the debt issuance spreads above average inter-bank rates (at a range of tenors) which the market would demand when purchasing new senior or sub-debt issuances from the Group. Where necessary, these quotes are interpolated using a curve shape derived from CDS prices.

The 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. No adjustments were made for own credit risk in relation to derivative liabilities in prior periods as it was not a significant factor in the pricing of derivative transactions by market participants. The change in methodology reflects market turbulence in 2008 which led to participants focussing increased attention on counterparty credit quality.

The table below shows the own credit spread adjustments on liabilities recorded in the income statement during the year.

	Debt securities in issue			Derivatives	Total
	Held-for-trading	Designated at fair value through profit and loss	Total		
	£m	£m	£m	£m	£m
At 1 January 2008	304	152	456	-	456
Effect of changes to credit spreads	376	583	959	450	1,409
Benefit of foreign exchange hedges	392	195	587	-	587
New issues	274	97	371	-	371
At 31 December 2008	1,346	1,027	2,373	450	2,823

8. SPEs and conduits

8.1 SPEs

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

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

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

Thereafter, losses are absorbed by investors in the lowest ranking notes in the priority of payments. Investors in the most senior ranking debt securities are typically shielded from loss, since any subsequent losses may trigger repayment of their initial principal.

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

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

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

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

The Group consolidates those SPEs where it holds the majority of the risks and rewards.

8.2 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 liquidity drawings. Commercial paper is typically short-dated – the length of time from issuance to maturity of the paper is typically up to three months.

The Group's conduits can be divided into multi-seller conduits and own-asset conduits. In line with market practice, the Group consolidates both types of conduit where it is exposed to the majority of risks and rewards of ownership of these entities. The Group also extends liquidity commitments to multi-seller conduits sponsored by other banks, but typically does not consolidate these entities as it is not exposed to the majority of the risks and rewards.

Funding and liquidity

The Group's most significant multi-seller conduits have thus far continued to fund the vast majority of their assets solely through ABCP issuance. There were significant disruptions to the liquidity of the financial markets during the year following the bankruptcy filing of Lehman Brothers in September 2008 and this required a small amount of the assets held in certain conduits to be funded by the Group rather than through ABCP issuance. By the end of 2008 there had been an improvement in market conditions, supported by central bank initiatives, which enabled normal ABCP funding to replace this Group funding of the conduits.

The average maturity of ABCP issued by the Group's conduits as at 31 December 2008 was 72.1 days (2007: 60.9 days).

The total assets held by the Group's sponsored conduits are £49.9 billion (2007: £48.1 billion). Since these liquidity facilities are sanctioned on the basis of total conduit purchase commitments, the liquidity facility commitments will exceed the level of assets held, with the difference representing undrawn commitments.

The Group values the funding flexibility and liquidity provided by the ABCP market to fund client and Group-originated assets. Whilst there are plans to decrease the multi-seller conduit business in line with the Group's balance sheet, the Group is reviewing the potential for new own-asset conduit structures to add funding diversity.

Multi-seller conduits

The multi-seller conduits were established by the Group for the purpose of providing its clients with access to diversified and flexible funding sources. A multi-seller conduit typically purchases or funds assets originated by the banks' clients. The multi-seller conduits form the vast majority of the Group's conduit business (69.4% of the total liquidity and credit enhancements committed by the Group). The Group sponsors six multi-seller conduits which finance assets from Europe, North America and Asia-Pacific.

Assets purchased or financed by the multi-seller conduits include auto loans, residential mortgages, credit card receivables, consumer loans and trade receivables. All assets held by the conduits are recorded on the Group's balance sheet either as loans and receivables or debt securities.

The third-party assets financed by the conduits are structured with a significant degree of first-loss credit enhancement provided by the originators of the assets. This credit enhancement, which is specific to each transaction, can take the form of over-collateralisation, excess spread or subordinated loan, and typically ensures the conduit asset has a rating equivalent to at least a single-A credit. In addition and in line with general market practice, the Group provides a small second-loss layer of programme-wide protection to the multi-seller conduits. Given the nature and investment grade equivalent quality of the first loss enhancement provided to the structures, the Group has only a minimal risk of loss on its program wide exposure. The issued ABCP is rated P-1 / A1 by Moody's and Standard & Poor's.

The Group provides liquidity back-up facilities to the conduits it sponsors. These facilities can be drawn upon by the conduits in the event of a disruption in the ABCP market, or when certain trigger events occur such that ABCP cannot be issued. For a very small number of transactions within two of the multi-seller conduits sponsored by the Group these liquidity facilities have been provided by third-party banks. This typically occurs on transactions where the third-party bank does not use, or have, its own conduit vehicles. Conduit commercial paper issuance is managed such that the spread of maturity dates of the issued ABCP mitigates the short-term contingent liquidity risk of providing back-up facilities. Group limits sanctioned for such facilities as at 31 December 2008 totalled approximately £42.9 billion (2007: £49.2 billion).

The Group's maximum exposure to loss on its multi-seller conduits is £43.2 billion (2007: £49.4 billion), being the total amount of the Group's liquidity commitments plus the extent of programme-wide credit enhancements which relate to conduit assets for whom liquidity facilities were provided by third parties.

Own-asset conduits

The Group also holds three own-asset conduits which fund assets which have been funded at one time by the Group. These vehicles represent 25% of the Group's conduit business (as a percentage of the total liquidity and credit enhancements committed by the Group), with £14.8 billion of ABCP outstanding at 31 December 2008 (2007: £10.4 billion). The Group's maximum exposure to loss on its own-asset conduits is £15.9 billion (2007: £13.5 billion), being the total drawn and undrawn amount of the Group's liquidity commitments to these conduits.

Securitisation arbitrage conduits

The Group no longer sponsors any securitisation arbitrage conduits. As part of the integration of ABN AMRO and a strategic review of the conduit business, the sole securitisation arbitrage conduit was dissolved in 2008. All of its assets were transferred to a centrally managed asset unit for run-off or sale.

The Group's exposure from both its consolidated conduits, including those to which the Group is economically exposed and those which are shared with the other consortium members, and its involvement with third-party conduits are set out below.

	31 December 2008			31 December 2007[1]		
	Sponsored conduits £m	Third party £m	Total £m	Sponsored conduits £m	Third party £m	Total £m
Total assets held by the conduits	**49,857**			48,070		
Commercial paper issued	**48,684**			46,532		
Liquidity and credit enhancements:						
• deal specific liquidity						
- drawn	**1,172**	**3,078**	**4,250**	1,537	2,280	3,817
- undrawn	**57,929**	**198**	**58,127**	61,347	490	61,837
• programme-wide liquidity						
- drawn	**-**	**102**	**102**	-	250	250
- undrawn	**-**	**504**	**504**	75	899	974
• PWCE [2]	**2,391**	**-**	**2,391**	3,096	-	3,096
	61,492	**3,882**	**65,374**	66,055	3,919	69,974
Maximum exposure to loss[3]	**59,101**	**3,882**	**62,983**	62,959	3,919	66,878

Notes
(1) Total assets held by the conduits and commercial paper issued at 31 December 2007 included:
(a) £5.2 billion assets and commercial paper issued relating to and by the Group's securitisation arbitrage conduit which was dissolved in 2008
(b) £10.7 billion assets (corporate loans) and £10.5 billion commercial paper issued relating to a shared conduit – see below.
(c) £1.3 billion assets relating to reactivated conduits which started to issue commercial paper in the second half of 2008
(2) Programme-wide credit enhancement
(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.

The Group's exposure from the conduit shared with the other consortium members are set out below:

	31 December 2008 £m	31 December 2007 £m
Total assets held by the conduits	**13,286**	10,650
Commercial paper issued	**13,028**	10,452
Liquidity and credit enhancements:		
• deal specific liquidity		
- drawn	**258**	198
- undrawn	**13,566**	11,868
• programme-wide liquidity	**-**	-
• PWCE	**-**	-
	13,824	12,066
Maximum exposure to loss	**13,824**	12,066

Collateral analysis, geographic, profile, credit ratings and weighted average lives of the assets in the assets relating to the Group's consolidated conduits and related undrawn commitments are set out in the tables below.

	31 December 2008						31 December 2007					
	Funded assets			Undrawn	Liquidity from third parties	Total exposure	Funded assets			Undrawn	Liquidity from third parties	Total exposure
	Loans	Securities	Total				Loans	Securities	Total			
Auto loans	**9,924**	**383**	**10,307**	**1,871**	**-**	**12,178**	8,066	578	8,644	3,701	(102)	12,243
Corporate loans	**430**	**11,042**	**11,472**	**534**	**-**	**12,006**	36	8,927	8,963	1,390	-	10,353
Credit card receivables	**5,844**	**-**	**5,844**	**922**	**-**	**6,766**	5,104	90	5,194	1,206	-	6,400
Trade receivables	**2,745**	**-**	**2,745**	**1,432**	**(71)**	**4,106**	3,068	320	3,388	2,386	-	5,774
Student loans	**2,555**	**-**	**2,555**	**478**	**(132)**	**2,901**	335	262	597	1,082	(132)	1,547
Consumer loans	**2,371**	**-**	**2,371**	**409**	**-**	**2,780**	1,886	-	1,886	403	-	2,289
Mortgages												
Prime	**4,416**	**2,250**	**6,666**	**1,188**	**-**	**7,854**	4,424	2,263	6,687	664	-	7,351
Non-conforming	**2,181**	**-**	**2,181**	**727**	**-**	**2,908**	2,343	234	2,577	740	-	3,317
Sub-prime	**-**	**-**	**-**	**-**	**-**	**-**	9	117	126	363	-	489
Commercial	**1,228**	**507**	**1,735**	**66**	**(23)**	**1,778**	799	1,094	1,893	168	(23)	2,038
Buy-to-let	**-**	**-**	**-**	**-**	**-**	**-**	-	61	61	8	-	69
CDOs	**-**	**-**	**-**	**-**	**-**	**-**	-	2,129	2,129	268	-	2,397
Other	**1,851**	**2,130**	**3,981**	**1,615**	**-**	**5,596**	2,976	2,947	5,923	2,433	-	8.356
	33,545	**16,312**	**49,857**	**9,242**	**(226)**	**58,873**	29,046	19,022	48,068	14,812	(257)	62,623

	CP funded assets										
	Geographic distribution						**Credit ratings (S&P equivalent)**				
	UK	**Europe**	**US**	**ROW**	**Total**	**Weighted average life**	**AAA**	**AA**	**A**	**BBB**	**Below BBB**
31 December 2008											
Auto loans	**801**	**1,706**	**7,402**	**398**	**10,307**	**1.7**	**6,075**	**883**	**3,349**	**-**	**-**
Corporate loans	**1,714**	**4,347**	**3,289**	**2,122**	**11,472**	**4.9**	**10,767**	**132**	**573**	**-**	**-**
Credit card receivables	**633**	**-**	**4,999**	**212**	**5,844**	**0.7**	**3,465**	**62**	**2,171**	**146**	**-**
Trade receivables	**68**	**922**	**1,371**	**384**	**2,745**	**0.7**	**120**	**1,025**	**1,600**	**-**	**-**
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	**-**	**2,244**	**-**	**4,422**	**6,666**	**2.8**	**2,675**	**3,876**	**115**	**-**	**-**
Non-conforming	**960**	**1,221**	**-**	**-**	**2,181**	**4.6**	**351**	**368**	**475**	**987**	**-**
Sub-prime	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Commercial	**713**	**453**	**74**	**495**	**1,735**	**11.0**	**274**	**518**	**474**	**469**	**-**
Buy-to-let	**-**	**-**	**-**	**-**	**-**		**-**	**-**	**-**	**-**	**-**
CDOs	**-**	**-**	**-**	**-**	**-**		**-**	**-**	**-**	**-**	**-**
Other	**166**	**1,198**	**684**	**1,993**	**3,981**	**1.2**	**3**	**958**	**2,786**	**234**	**-**
	5,907	**13,286**	**20,698**	**10,000**	**49,857**	**2.8**	**26,413**	**8,959**	**12,581**	**1,904**	**-**

	Geographic distribution					Weighted average life	Credit ratings (S&P equivalent)				
	UK	Europe	US	ROW	Total		AAA	AA	A	BBB	Below BBB
31 December 2007											
Auto loans	2,250	1,259	4,793	341	8,643	1.9	1,457	3,184	3,940	62	-
Corporate Loans	1,127	1,551	4,658	1,627	8,963	6.5	8,839	15	110	-	-
Credit card receivables	654	-	4,402	138	5,194	1.0	1,287	913	2,848	147	-
Trade receivables	299	816	1,965	309	3,389	0.9	186	732	2,183	236	51
Student loans	140	-	457	-	597	1.6	270	311	16	-	-
Consumer loans	648	724	514	-	1,886	1.2	1,018	473	395	-	-
Mortgages										-	-
Prime	276	565	983	4,863	6,687	3.3	1,897	2,181	2,610	-	-
Non-conforming	1,675	833	-	69	2,577	5.1	268	1,596	713	-	-
Sub-prime	-	-	9	117	126	0.2	117	-	9	-	-
Commercial	1,023	233	198	439	1,893	9.6	746	630	401	116	-
Buy-to-let	61	-	-	-	61	-	37	24		-	-
CDOs	137	520	1,473	-	2,130	2.7	2,114	15	-	-	-
Other	579	1,071	1,950	2,323	5,923	2.8	2,363	784	2,652	125	-
	8,869	7,572	21,402	10,226	48,069	3.3	20,599	10,858	15,877	686	51

8.3 SIVs

The Group does not sponsor any structured investment vehicles.

8.4 Investment funds set up and managed by the Group

The Group's investment funds are managed by RBS Asset Management (RBSAM), which is an integrated asset management business, which manages investments on behalf of third-party institutional and high net worth investors, as well as for the Group. RBSAM is active in most traditional asset classes and employs both fund of funds structures and multi-manager strategies. Its offering includes money market funds, long only funds and alternative investment funds.

Money market funds

The Group has established and manages a number of money market funds for its customers. When a new fund is launched, RBS as fund manager typically provides a limited amount of seed capital to the funds. RBS does not have investments in these funds greater than £25 million. As RBS does not have holdings in these funds of significant size and as the risks and rewards of ownership are not with RBS, these funds are not consolidated by RBS.

The funds have been authorised by the Irish Financial Services Regulatory Authority as UCITS pursuant to the UCITS Regulations (UCITS Regulations refer to the European Communities' Undertakings for Collective Investment in Transferable Securities Regulations) and are therefore restricted in the types of investments and borrowings they can make. The structure of the assets within the funds is designed to meet the liabilities of the funds to their investors who have no recourse other than to the assets of the funds. The risks to RBS as a result are restricted to reputational damage if the funds were unable to meet withdrawals when requested on a timely basis or in full.

The RBS money market funds had total assets of £13.6 billion at 31 December 2008 (31 December 2007: £11.2 billion). The sub categories of money market funds are:

- £8.0 billion (2007: £5.1 billion) in Money Funds denominated in sterling, US dollars and euro, which invest in short-dated, highly rated money market securities with the objective of providing security, performance and liquidity.
- £4.9 billion (2007: £5.5 billion) in multi-manager money market funds denominated in sterling, US dollars and euro, which invest in short dated, highly rated securities.
- £0.7 billion (2007: £0.6 billion) in Money Funds Plus denominated in sterling, US dollars and euro, which invest in longer-dated, highly rated securities with the objective of providing security, enhanced performance and liquidity.

Non-money market funds

The Group has also established a number of non-money market funds to enable investors to invest in a range of assets including bonds, equities, hedge funds, private equity and real estate. The Group does not have investments in these funds greater than £200 million. Since it does not have significant holdings in these funds and the risks and rewards of ownership are not retained, these funds are not consolidated by the Group.

The non-money market funds had total assets of £18.7 billion at 31 December 2008 (31 December 2007: £19.4 billion). The sub categories of non-money market funds are:

- £16.0 billion (2007: £17.0 billion) in multi-manager funds, which offer fund of funds products across bond, equity, hedge fund, private equity and real estate asset classes.
- £1.6 billion (2007: £1.3 billion) in committed capital to private equity investments, which invests primarily in equity and debt securities of private companies.
- £1.1 billion (2007: £1.1 billion) in credit investments, which invests in various financial instruments.

The structure of the assets within the funds is designed to meet the liabilities of the funds to their investors who have no recourse other than to the assets of the funds. The risks to the Group as a result are restricted to reputational damage if the funds were unable to meet withdrawals when requested on a timely basis or in full, and the Group's own investment in the funds.

The Group's maximum exposure to non-money market funds is represented by the investment in the shares of each fund and was £200 million at 31 December 2008 (2007: £171 million).