ROYAL BANK OF SCOTLAND GROUP PLC
Form 20-F
March 29, 2005

# FORM 20-F

| | | |
|---|---|---|
| (Mark one) | o | REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934 |
| OR | x | ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 |
| For the fiscal year ended | | **31 December 2004** |
| OR | o | TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934<br>For the transition period from __________ to __________ |
| Commission file number | | **1-10306** |

## The Royal Bank of Scotland Group plc
## Scotland
## 42 St Andrew Square, Edinburgh EH2 2YE United Kingdom

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

| Title of each class | Name of each exchange on which registered |
|---|---|
| American Depositary Shares Series D, E, F, G, H, I, J, K, L and M each representing one Non-Cumulative Dollar Preference Share, Series D, E, F, G, H, I, J, K, L and M, respectively | New York Stock Exchange |
| Exchangeable Capital Securities, Series A | New York Stock Exchange |
| Non-Cumulative Dollar Preference Shares* | New York Stock Exchange |
| Dollar Perpetual Regulatory tier one securities, Series 1 | New York Stock Exchange |

* Issuable upon exchange of the Exchangeable Capital Securities

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

None

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

None

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report.

| | | | |
|---|---|---|---|
| Ordinary shares of 25 pence each | 3,172,605,080 | Non-cumulative dollar preference shares, Series D to M | 153,000,000 |
| Non-voting Deferred Shares | 2,660,556,304 | Non-cumulative convertible dollar preference shares, Series 1 to 3 | 1,900,000 |
| 11% cumulative preference shares | 500,000 | Non-cumulative euro preference shares, Series 1 | 1,250,000 |
| 5½% cumulative preference shares | 400,000 | Non-cumulative convertible euro preference shares, Series 1 | 750,000 |
| | | Non-cumulative convertible sterling preference shares, Series 1 | 200,000 |

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

x **YES** o **NO**

Indicate by check mark which financial statement item the registrant has elected to follow. o **Item 17** x **Item 18**

**SEC Form 20-F cross reference guide**


| Item | Item Caption | Pages |
|---|---|---|
| PART I | | |
| 1 | Identity of Directors, Senior Management and Advisers | Not applicable |
| 2 | Offer Statistics and Expected Timetable | Not applicable |
| 3 | Key Information | |
| | Selected financial data | 148 - 151, 159 |
| | Capitalisation and indebtedness | Not applicable |
| | Reasons for the offer and use of proceeds | Not applicable |
| | Risk factors | 6 |
| 4 | Information on the Company | 17 - 20, 46 - 49, 103, 151 - 158 |
| | History and development of the Company | 4 - 6, 62, 92, 106, 166, 171, 183 |
| | Business overview | 4 - 5, 130 - 132, 162 - 165 |
| | Organisational structure | 4, 104, 183 |
| | Property, plants and equipment | 166 |
| 5 | Operating and Financial Review and Prospects | |
| | Operating results | 12 - 41, 57, 122, 162 - 165 |
| | Liquidity and capital resources | 40 - 41, 50 - 53, 62, 121 - 124, 158, 160 - 165 |
| | Research and development, patents and licences etc. | Not applicable |
| | Trend information | 6 - 7, 159 |
| | Off-balance sheet arrangements | 160-161 |
| | Contractual obligations | 161 |
| 6 | Directors, Senior Management and Employees | |
| | Directors and senior management | 60-61 |
| | Compensation | 70 - 79 |
| | Board practices | 61, 66 - 69, 73 - 75 |
| | Employees | 37 |
| | Share ownership | 64, 77 - 78, 80 |
| 7 | Major Shareholders and Related Party Transactions | |
| | Major shareholders | 63, 166 |
| | Related party transactions | 133 |
| | Interests of experts and counsel | Not applicable |
| 8 | Financial Information | |
| | Consolidated statements and other financial information | 84 - 145 |
| | Significant changes | 145 |

| Item | | Item Caption | Pages |
|---|---|---|---|
| 9 | | The Offer and Listing | |
| | | Offer and listing details | 170 |
| | | Plan of distribution | Not applicable |
| | | Markets | 169 - 170 |
| | | Selling shareholders | Not applicable |
| | | Dilution | Not applicable |
| | | Expenses of the issue | Not applicable |
| 10 | | Additional Information | |
| | | Share capital | Not applicable |
| | | Memorandum and articles of association | 171 - 177 |
| | | Material contracts | 166 |
| | | Exchange controls | 182 |
| | | Taxation | 177 - 181 |
| | | Dividends and paying agents | Not applicable |
| | | Statement by experts | Not applicable |
| | | Documents on display | 182 |
| | | Subsidiary information | Not applicable |
| 11 | | Quantitative and Qualitative Disclosures about Market Risk | 42 - 58, 118 - 122, 152 - 158 |
| 12 | | Description of Securities other than Equity Securities | Not applicable |
| PART II | | | |
| 13 | | Defaults, Dividend Arrearages and Delinquencies | Not applicable |
| 14 | | Material Modifications to the Rights of Security Holders and Use of Proceeds | Not applicable |
| 15 | | Controls and Procedures | 69 |
| 16 | | [Reserved] | |
| 16A | A | Audit Committee financial expert | 67 |
| | B | Code of ethics | 67 |
| | C | Principal Accountant Fees and services | 67, 96 |
| | D | Exemptions from the Listing Standards for Audit Committee | Not applicable |
| | E | Purchases of Equity Securities by the Issuer and Affiliated Purchasers | |
| | | No such purchases were made during the year ended 31 December 2004. | |
| PART III | | | |
| 17 | | Financial Statements | Not applicable |
| 18 | | Financial Statements | 84 - 145 |
| 19 | | Exhibits | 186 |

| | |
|---|---|
| Signature | 187 |



**Operating and financial review**

## Contents

**2** Presentation of information

**3** Forward-looking statements

**4** Description of business

**6** Risk factors

**6** Critical accounting policies

**9** Accounting developments

**12** Financial highlights

**13** Summary consolidated profit and loss account

**17** Analysis of results

**25** Divisional performance

**38** Consolidated balance sheet

**40** Cash flow

**41** UK GAAP compared with US GAAP

**41** Capital resources

**42** Risk management



**Presentation of information**

In the Report and Accounts, and unless specified otherwise, the term "company" means The Royal Bank of Scotland Group plc, "RBS" or the "Group" means the company and its subsidiary undertakings, "the Royal Bank" means The Royal Bank of Scotland plc and "NatWest" means National Westminster Bank Plc.

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

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

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

The Group distinguishes its trading from non-trading activities by determining whether a business unit's principal activity is trading or non-trading and then attributing all of that unit's activities to one portfolio or the other. Although this method may result in some non-trading activity being classified as trading, and vice versa, the Group believes that any resulting misclassification is not material.

In this report, the terms "UK GAAP" and "US GAAP" refer to generally accepted accounting principles ("GAAP") in the UK and the US, respectively.

2

---

## Forward-looking statements

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

In particular, this document includes forward-looking statements relating, but not limited, to the Group's 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: 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.

For a further discussion of certain risks faced by the Group, see Risk factors on page 6.



## Operating and financial review

### Description of business

*Introduction*

The Royal Bank of Scotland Group plc is the holding company of one of the world's largest banking and financial services groups, with a market capitalisation of £55.6 billion at the end of 2004. Headquartered in Edinburgh, the Group operates in the UK, US and internationally through its two principal subsidiaries, the Royal Bank and NatWest. Both the Royal Bank and NatWest are major UK clearing banks whose origins go back over 275 years. In the US, the Group's subsidiary, Citizens is ranked the eighth largest commercial banking organisation by deposits. The Group has a large and diversified customer base and provides a wide range of products and services to personal, commercial and large corporate and institutional customers.

The Group had total assets of £583 billion and ordinary shareholders' equity of £27.3 billion at 31 December 2004. It is strongly capitalised with a total capital ratio of 11.7% and tier 1 capital ratio of 7.0% as at 31 December 2004.

*Organisational structure and business overview*

The Group's activities are organised in the following business divisions: Corporate Banking and Financial Markets, Retail Banking, Retail Direct, Manufacturing, Wealth Management, RBS Insurance, Ulster Bank and Citizens. A description of each of the divisions is given below.

*Corporate Banking and Financial Markets ("CBFM")* is the largest provider of banking services to medium and large businesses in the UK with growing presence in the US, Europe and Asia. It provides an integrated range of products and services including corporate and commercial banking, treasury and capital markets products, structured and leveraged finance, trade finance, leasing and factoring.

Within CBFM, Financial Markets provides corporate and institutional customers with treasury services, including global interest rate derivatives trading, bond origination and trading, sovereign debt trading, futures brokerage, foreign exchange, money market, currency derivative and rate risk management services. RBS Greenwich Capital, with headquarters in Connecticut, US, delivers debt market solutions tailored to meet the needs of companies and institutions around the world.

*Retail Banking* is one of the leading retail banks in the UK. The division comprises both the Royal Bank and NatWest retail brands. It offers a full range of banking products and related financial services to the personal, premium and small business markets.

In the personal banking market, Retail Banking offers a comprehensive product range: money transmission, savings, loans, mortgages and insurance. In the small business market, Retail Banking provides a full range of services which include money transmission and cash management, short, medium and long-term financing, deposit products and insurance.

Customer choice and product flexibility are central to the Retail Banking proposition and customers are able to access services through a full range of channels: branches, ATMs, the internet and the telephone.

*Retail Direct* consists of the Group’s non-branch based retail businesses. Retail Direct issues a comprehensive range of credit, charge and debit cards to personal and corporate customers and provides merchant acquisition and processing facilities for retail businesses. It also includes Tesco Personal Finance (“TPF”), The One account, Direct Line Financial Services (“DLFS”), Lombard Direct, WorldPay Limited, the Group’s internet banking platform, the Primeline brand and in Europe, the Comfort Card businesses, all of which offer products to customers through direct channels.

During 2004 Retail Direct expanded its international operations. In the US, it acquired the credit card business of People’s Bank, Lynk systems Inc., a leading merchant acquirer and entered into an agreement to issue credit cards to the customers of Kroger, a leading supermarket chain. In continental Europe, Retail Direct acquired Bibit NV, a leading internet payment specialist and agreed to provide consumer finance services through the outlets of Tchibo, a leading German retailer.

*Manufacturing* supports the customer facing businesses in the UK and Ireland and manages the Group’s telephony, account management and money transmission operations. It is also responsible for information technology operations and development, global purchasing, property and other services.

Manufacturing drives optimum efficiencies in high volume processing activities, leverages the Group's purchasing power and has become a centre of excellence for managing large scale and complex change programmes such as integration.

*Wealth Management* provides private banking and investment services to its clients through a number of leading UK and overseas private banking subsidiaries and offshore banking businesses. Coutts is one of the world’s leading international wealth managers with over 50 offices worldwide, including Switzerland, Dubai, Monaco, Hong Kong and Singapore, as well as its premier position in the UK. Adam & Company is the major private bank in Scotland. The offshore banking businesses – The Royal Bank of Scotland International and NatWest Offshore – deliver retail banking services to local and expatriate customers, and corporate banking and treasury services to corporate, intermediary and institutional clients, principally in the Channel Islands, the Isle of Man and Gibraltar.

*RBS Insurance* is the second largest general insurer in the UK, by gross earned premiums. Through the Direct Line, Churchill and Privilege brands it sells and underwrites personal insurance over the telephone and the internet in the UK. Through the red phone brand, RBS Insurance also sells and



underwrites personal insurance in Spain, Italy and Germany. UKI Partnerships is a leading provider of insurance and motoring related services through partner brands, including through Tesco Personal Finance. NIG sells personal and commercial products through a network of intermediaries, while Inter Group acts as an insurance administrator and Devitt Insurance Services operates as a specialist broker administrator.

*Ulster Bank* provides a comprehensive range of retail and corporate banking services in Northern Ireland and the Republic of Ireland. In retail banking, Ulster Bank operates a network of branches throughout Ireland serving personal and commercial customers. Corporate Banking and Financial Markets provides a wide range of services in the corporate and institutional markets.

In January 2004 Ulster Bank acquired First Active plc, a leading provider of mortgages, retail savings and investment products in the Republic of Ireland. First Active and Ulster Bank have retained their own distinctive brands, branch networks and customer propositions, with efficiencies derived from shared central manufacturing activities.

*Citizens* is the second largest commercial banking organisation in New England and the eighth largest commercial banking organisation in the US measured by deposits. Citizens provides retail and corporate banking services under the Citizens brand in the states of Connecticut, Delaware, Massachusetts, New Hampshire, New Jersey, Pennsylvania and Rhode Island, and the Charter One brand in the states of Illinois, Indiana, Michigan, New York, Ohio and Vermont. Through its branch network Citizens provides a full range of retail and corporate banking services, including personal banking, residential mortgages and cash management. In addition, Citizens engages in a wide variety of commercial lending, consumer lending, commercial and consumer deposit products, merchant credit card services, insurance products, trust services and retail investment services.

During 2004, Citizens completed the acquisitions of Thistle Group Holdings, Co., the holding company of Roxborough Manayunk Bank and Charter One Financial Group, Inc., the holding company of Charter One Bank.

**Competition**

The Group faces intense competition in all the markets it serves. In the UK, the Group's principal competitors are the other UK retail and commercial banks, building societies (which are similar to savings and loans associations in the US) and the other major international banks represented in London.

Competition for corporate and institutional customers in the UK is from UK banks and from large foreign financial institutions who are also active and offer combined investment and commercial banking capabilities. In asset finance, the Group competes with banks and specialised asset finance providers, both captive and non-captive.

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

In the personal banking segment the Group competes with UK banks and building societies, major retailers, life assurance companies and internet-only players. In the mortgage market where the Group competes with UK banks and building societies, re-mortgaging activity by customers has been at a high level. NatWest Life and Royal Scottish Assurance compete with Independent Financial Advisors and life assurance companies. The competitive situation in the long term savings market is dynamic due to the uncertainties created by regulatory change and continued evolution of institutions, particularly in the mutual sector.

In the UK credit card market large retailers and specialist card issuers, including major US operators, are active in addition to the UK banks and building societies. Competitive pressure includes aggressive pricing, loyalty and reward schemes, and packaged benefits. In addition to physical distribution channels, providers compete through direct marketing activity and, increasingly, the internet.

In Wealth Management, The Royal Bank of Scotland International and NatWest Offshore compete with other UK and international banks to offer offshore banking services. Coutts and Adam & Company compete as private banks with UK clearing and private banks, and with international private banks.

RBS Insurance competes in personal lines insurance and to a limited extent in commercial insurance. There is competition from a range of insurance companies which now operate telephone and internet direct sales businesses. RBS Insurance also competes with local insurance companies in the direct motor insurance markets in Spain, Italy and Germany.

In Ireland, Ulster Bank and First Active compete in retail and commercial banking with the major Irish banks and building societies, and with other UK and international banks and building societies active in the market. Competition is intensifying as both UK, Irish and other European institutions seek to expand their businesses.

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

In other international markets, principally in continental Europe, the Group faces competition from the leading domestic and international institutions active in the relevant national markets.



---

## **Operating and financial review** continued

### Risk factors

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

*The financial performance of the Group is affected by borrower credit quality and general economic conditions, in particular in the UK, US and Europe*

Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent in a wide range of the Groups businesses. Adverse changes in the credit quality of the Groups borrowers and counterparties or a general deterioration in UK, US, European or global economic conditions, or arising from systemic risks in the financial systems, could affect the recoverability and value of the Groups assets and require an increase in the provision for bad and doubtful debts and other provisions.

*Changes in interest rates, foreign exchange rates, equity prices and other market factors affect the Groups business*

The most significant market risks the Group faces are interest rate, foreign exchange and bond and equity price risks. Changes in interest rate levels, yield curves and spreads may affect the interest rate margin realised between lending and borrowing costs. Changes in currency rates, particularly in the sterling-dollar and sterling-euro exchange rates, affect the value of assets and liabilities denominated in foreign currencies and affect earnings reported by the Groups non-UK subsidiaries, mainly Citizens, RBS Greenwich Capital and Ulster Bank, and may affect income from foreign exchange dealing. The performance of financial markets may cause changes in the value of the Groups investment and trading portfolios. The Group has implemented risk management methods to mitigate and control these and other market risks to which the Group is exposed. However, it is difficult to predict with accuracy changes in economic or market conditions and to anticipate the effects that such changes could have on the Groups financial performance and business operations.

*The Groups insurance businesses are subject to inherent risks involving claims*

Future claims in the Groups general and life assurance business may be higher than expected as a result of changing trends in claims experience resulting from catastrophic weather conditions, demographic developments, changes in mortality and other causes outside the Groups control. Such changes would affect the profitability of current and future insurance products and services. The Group re-insures some of the risks it has assumed.

*Operational risks are inherent in the Groups business*

The Groups businesses are dependent on the ability to process a very large number of transactions efficiently and accurately. Operational losses can result from fraud, errors by employees, failure to document transactions properly or to obtain proper authorisation, failure to comply with regulatory requirements and Conduct of Business rules, equipment failures, natural disasters or the failure of external systems, for example, the Groups suppliers or counterparties. Although the Group has implemented risk controls and loss mitigation actions, and substantial resources are devoted to developing efficient procedures and to staff training, it is only possible to be reasonably, but not absolutely, certain that such procedures will be effective in controlling each of the operational risks faced by the Group.

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

The Group is subject to financial services laws, regulations, administrative actions and policies in each location in which the Group operates. This supervision and regulation, in particular in the UK, if changed could materially affect the Groups business, the products and services offered or the value of assets.

*Future growth in the Groups earnings and shareholder value depends on strategic decisions regarding organic growth and potential acquisitions*

The Group devotes substantial management and planning resources to the development of strategic plans for organic growth and identification of possible acquisitions, supported by substantial expenditure to generate growth in customer business. If these strategic plans do not meet with success, the Groups earnings could grow more slowly or decline.

**Critical accounting policies**

The reported results of the Group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. The Groups principal accounting policies are set out on pages 85 to 88. UK company law and accounting standards require the directors, in preparing the Groups financial statements, to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent. Where UK GAAP allows a choice of policy, Financial Reporting Standard (FRS) 18 Accounting Policies requires an entity to adopt those policies judged to be most appropriate to its particular circumstances for the purpose of giving a true and fair view.

The judgements and assumptions involved in the Groups accounting policies that are considered by the Board to be the most important to the portrayal of its financial condition are discussed below. The use of estimates, assumptions or models that differ from those adopted by the Group would affect its reported results.



---

*Provisions for bad and doubtful debts*

The Group provides for losses existing in its lending book so as to state its loan portfolio at its expected ultimate net realisable value. Specific provisions are established against individual exposures and the general provision covers advances impaired at the balance sheet date but which have not been identified as such. Bad and doubtful debt provisions made during the year less amounts released and recoveries of amounts written-off in previous years are charged to the profit and loss account. Loans and advances are reported on the balance sheet net of specific and general provisions.

For certain homogeneous portfolios, including credit card receivables and other personal advances including mortgages, specific provisions are established on a portfolio basis, taking into account the level of arrears, security, past loss experience, credit scores and defaults based on portfolio trends. The most significant factors in establishing these provisions are the expected loss rates and the related average life. These factors are kept under constant review by the Group.

Other loans and advances are individually assessed and the specific provision is determined from a review of the financial condition of the borrower and any guarantor and takes into account the customer's debt capacity and financial flexibility; the level and quality of earnings; the amount and sources of cash flows; the industry in which the customer operates; and the realisable value of any security held. The most significant estimates that affect the quantum of a specific provision are the receipts from the borrower and the amount that will be recovered from any security held.

Evaluating these estimates involves significant judgement as receipts will depend on the future performance of the borrower and the value of security, both of which will be affected by future economic conditions. Additionally, the security may not be readily marketable.

The general provision covers bad and doubtful debts that have not been separately identified at the balance sheet date but are known to be present in any portfolio of advances. The level of general provision is assessed in the light of past experience and reflects the size and diversity of the Group's loan portfolio, the current state of the economies in which the Group operates, other factors affecting the business environment, recent trends in companies going into administration, receivership and bankruptcy and the Group's monitoring and control procedures, including the scope of specific provisioning procedures.

The future credit quality of the Group's lending book is subject to uncertainties that could cause actual credit losses to differ materially from reported loan loss provisions. These uncertainties include the economic environment, notably interest rates and their effect on customer spending, the unemployment level, payment behaviour and bankruptcy trends and changes in the Group's portfolios.

*Loans and advances – recognition of interest income*

Interest receivable from loans and advances is credited to the profit and loss account as it accrues unless there is significant doubt that it can be collected. If the collection of interest is in doubt, it is credited to a suspense account and excluded from interest receivable; it continues to be charged to the customer's account.

*Pensions*

The Group operates a number of defined benefit pension schemes as described in Note 3 on the financial statements. The assets of the schemes are measured at their fair value at the balance sheet date. Scheme liabilities are measured using the projected unit method, which takes account of projected earnings increases, using actuarial assumptions that give the best estimate of the future cash flows that will arise under the scheme liabilities. These cash flows are discounted at the interest rate applicable to high-quality corporate bonds of the same currency and term as the liabilities. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit). An asset is only recognised to the extent that the surplus can be recovered through reduced contributions in the future or through refunds from the scheme. In determining the value of scheme liabilities assumptions are made as to price inflation, dividend growth, pension increases, earnings growth and employees. There is a range of assumptions that could be adopted in valuing the schemes' liabilities. Different assumptions could significantly alter the amount of the deficit recognised in the balance sheet and the pension cost charged to the profit and loss account. The assumptions underlying the 2004 deficit and pension cost are set out in Note 3 on the financial statements.

*Fair value*

Securities and derivatives held for trading purposes are recognised in the financial statements at fair value. In the balance sheet, trading securities are included within Treasury and other eligible bills, Debt securities and Equity shares as appropriate. Positive fair values (assets) of trading derivatives are included in Other assets and negative fair values (liabilities) in Other liabilities. Positive and negative fair values of trading derivatives are offset where the contracts have been entered into under master netting agreements or other agreements that give a legally enforceable right of set-off. Gains or losses arising from changes in fair value are included in Dealing profits in the profit and loss account.

Fair value is the value at which a position could be closed out or sold in a transaction to a willing and knowledgeable counterparty over a reasonable period of time under current market conditions. Fair values are determined by reference to observable market prices where available and reliable. Where representative market prices for an instrument are not available or are unreliable because of poor liquidity, the fair value is derived from prices for its components using appropriate pricing or valuation models that are based on independently sourced market parameters, including interest rate yield curves, option volatilities and currency rates.



---

## **Operating and financial review** continued

Securities carried at fair value include government, asset-backed and corporate debt obligations and corporate equity shares. Fair value for a substantial proportion of these instruments is based on observable market prices or derived from observable market parameters. Determining fair value for such instruments does not involve significant judgement. Where observable prices are not available or if a position could be liquidated only at an unfavourable price or over an extended period, fair value is based on appropriate valuation techniques or management estimates.

The Group's derivative products include swaps, forwards, futures and options. Exchange traded instruments are valued using quoted prices. The fair value of over-the-counter instruments is derived from pricing models which take account of contract terms, including maturity, as well as quoted market parameters such as interest rates and volatilities. Most of the Group's pricing models do not entail material subjectivity because the methodologies utilised do not incorporate significant judgement and the parameters included in the models can be calibrated to actively quoted market prices. Values established from pricing models are adjusted for credit risk, liquidity risk and future operational costs.

A negligible proportion of the Group's trading derivatives are valued directly from quoted prices, the majority being valued using appropriate valuation techniques. The fair value of substantially all securities positions carried at fair value is determined directly from quoted prices.

*General insurance claims*

The Group makes provision for the full cost of settling outstanding claims arising from its general insurance business at the balance sheet date, including claims estimated to have been incurred but not yet reported at that date and claims handling expenses. Claims are recognised in the accounting period in which the loss occurs.

Provisions are determined by management based on experience of claims settled and on statistical models which require certain assumptions to be made regarding the incidence, timing and amount of claims and any specific factors such as adverse weather conditions. In order to calculate the total provision required, the historical development of claims is analysed using statistical methodology to extrapolate, within acceptable probability parameters, the value of outstanding claims at the balance sheet date. Also included in the estimation of outstanding claims are other assumptions such as the inflationary factor used for bodily injury claims which is based on historical trends and, therefore, allows for some increase due to changes in common law and statute. Costs for both direct and indirect claims handling expenses are also included. Outward reinsurance recoveries are accounted for in the same accounting period as the direct claims to which they relate.

The outstanding claims provision is based on information available to management and the eventual outcome may vary from the original assessment. Actual claims experience may differ from the historical pattern on which the estimate is based and the cost of settling individual claims may exceed that assumed.

*Goodwill*

The Group capitalises goodwill arising on the acquisition of businesses, as disclosed in the Accounting policies. Goodwill is the excess of the cost of an acquisition and the fair value of its net assets. The determination of the fair value of assets and liabilities of businesses acquired requires the exercise of management judgement; for example those financial assets and liabilities for which there are no quoted prices, and those non-financial assets where valuations reflect estimates of market conditions such as property. Different fair values would result in changes to the goodwill arising and to the post-acquisition performance of the acquisition. Under UK GAAP goodwill is amortised and there is a rebuttable presumption that the useful economic life of purchased goodwill does not exceed 20 years from the date of acquisition. The useful economic life of acquired goodwill is assessed on the basis of the type and diversity of the business, its location and the markets in which it operates. Under US GAAP goodwill is not amortised but is subject to annual review for impairment.

An impairment test is designed to assess the recoverable amount of an asset or, in the case of goodwill, an operating segment, by comparing its carrying value with the discounted value of future cash flows that it will generate. Impairment testing inherently involves a number of judgmental areas: the preparation of cash flow forecasts for periods that are beyond the normal requirements of management reporting, the valuation of the separable assets of each business whose goodwill is being reviewed and an assessment of the discount rate appropriate to the business. Under UK GAAP, impairment tests are only undertaken in the year following an acquisition or when there is evidence that impairment might have occurred. US GAAP requires annual impairment tests that are different from any UK tests and accordingly they may support a different carrying value for the asset being tested.



---

**Accounting developments**

*UK GAAP*

UITF Abstract 38 Accounting for ESOP trusts and the consequential amendment to UITF Abstract 17 Employee share schemes which are applicable for the year ended 31 December 2004 did not have a material effect on the Group.

The Accounting Standards Board issued FRS 27 Life Assurance which introduces a new realistic method of measuring life assurance liabilities and related assets. The present value of in-force polices can continue to be recognised provided that future investment margins are not included. The standard is applicable under UK GAAP for years ending on or after 31 December 2005 and is not expected to have a material effect on the Group.

*International Financial Reporting Standards*

In June 2002, the European Union adopted a regulation that requires, from 1 January 2005, listed companies to prepare their financial statements in accordance with international accounting standards adopted by the EU. The Groups 2005 financial statements will therefore be prepared in accordance with International Financial Reporting Standards (IFRS). These comprise not only IFRS but also International Accounting Standards (IAS).

IFRS differ in certain significant respects from the Groups accounting policies under UK GAAP. The summary below outlines the important differences for the Group in respect of recognition and measurement on the basis of extant IFRS that will be effective for 2005, including revised IAS 32 and IAS 39:

*Goodwill*  IFRS require goodwill arising on the acquisition of subsidiaries or associates to be capitalised. Amortisation of goodwill is prohibited but it must be tested annually for impairment (and whenever changes in circumstances indicate impairment). Under the Group's UK GAAP accounting policy, goodwill arising on acquisitions after 1998 is recognised as an asset and amortised on a straight-line basis over its useful economic life. Impairment tests are carried out at the end of the first full accounting period after its acquisition, and whenever there are indications of impairment. Goodwill arising on acquisitions before 1 October 1998 was deducted from reserves immediately. Certain amounts that would be included as goodwill under UK GAAP are recognised as intangibles under IFRS. Such intangibles are amortised over their useful lives unless they are regarded as having an indefinite useful life in which case they are not amortised but tested for impairment annually (and whenever changes in circumstances indicate impairment).

*Merger accounting* – IFRS require all business combinations to be accounted for as acquisitions by applying the purchase method. UK GAAP requires business combinations meeting certain criteria to be accounted for using merger accounting.

*Dividends* – IFRS require dividends payable to be recorded in the period in which they are declared whereas under UK GAAP dividends are recorded in the period to which they relate.

*Computer software* – under UK GAAP, most software development costs are written off as incurred. Under IFRS, such costs are capitalised if certain conditions are met and amortised over the estimated useful life of the software.

*Pensions* – the Group has implemented FRS 17 'Retirement Benefits' (FRS 17) for 2004. The measurement principles of this standard are similar to those required by IFRS. IFRS, like FRS 17, allow actuarial gains and losses to be recognised outside the profit and loss account. However IFRS allow as alternatives actuarial gains and losses to be recognised in profit or loss either in the period in which they occur or on a deferred basis.

*Share-based payments* – under UK GAAP, no compensation expense is recognised for Inland Revenue approved Save-as-you-earn share option schemes or for other share option schemes where the option has no intrinsic value (i.e. where at date of grant the exercise price equals the market value). IFRS require the fair value of share options at the date of grant to be recognised as an expense

*Financial instruments: financial assets* – under UK GAAP, loans are measured at cost less provisions for bad and doubtful debts, derivatives held for trading are carried at fair value and hedging derivatives are accounted for in accordance with the treatment of the item being hedged (see ‘Derivatives and hedging’ below), and securities are classified as being held as investment securities, or held for dealing purposes. Investment debt securities are stated at cost less provision for any permanent diminution in value. Premiums and discounts on dated securities are amortised to interest income over the period to maturity. Other securities are carried at fair value. Under IFRS, financial assets are classified into held-to-maturity; available-for-sale; held for trading; designated as fair value through profit or loss; and loans and receivables. Financial assets classified as held-to-maturity or as loans and receivables are carried at amortised cost. Other financial assets are measured at fair value. Changes in the fair value of available-for-sale financial assets are reported in a separate component of shareholders’ equity. Changes in the fair value of financial assets held for trading or designated as fair value are taken to the profit and loss account. Financial assets can be classified as held-to-maturity only if they have a fixed maturity and the reporting entity has the positive intention and ability to hold to maturity. Trading financial assets are held for the purpose of selling in the near term. IFRS allow any financial asset to be designated as fair value through profit and loss on initial recognition. Unquoted debt financial assets that are not classified as held-to-maturity, held for trading or designated as fair value through profit or loss are categorised as loans and receivables. All other financial assets are classified as available-for-sale.

*Effective interest rate and lending fees* – under UK GAAP, loan origination fees are recognised when receivable unless they are charged in lieu of interest. IFRS require origination fees to be deferred and recognised as an adjustment to the effective interest rate on the related financial asset. The effective interest rate is the rate that discounts estimated future cash flows over

## **Operating and financial review** continued

an instrument’s expected life to its net carrying value. It takes into account all fees and points paid that are an integral part of the yield, transaction costs and all other premiums and discounts. Under IFRS, the carrying value of a financial instrument held at amortised cost is calculated using the effective interest method.

*Loan impairment* – under UK GAAP, provisions for bad and doubtful debts are made so as to record impaired loans at their expected ultimate net realisable value. IFRS require impairment losses on financial assets carried at amortised cost to be measured as the difference between the asset’s carrying amount and the present value of estimated future cash flows discounted at the asset’s original effective interest rate. Impairment must be assessed individually for individually significant assets but can be assessed collectively for other assets.

*Financial instruments: financial liabilities* – IFRS require all financial liabilities to be measured at amortised cost except those held for trading and those that were designated as fair value through profit and loss on initial recognition. Under UK GAAP, short positions in securities and trading derivatives are carried at fair value, all other financial liabilities are recorded at amortised cost. In IFRS as adopted by the EU, the option to designate at fair value through profit and loss is not available.

*Liabilities and equity* – under UK GAAP, all issued shares are classified as shareholders’ funds, and analysed between equity and non-equity interests. There is no concept of non-equity shares in IFRS. Instruments are classified between equity and liabilities in accordance with the substance of the contractual arrangements. A non-derivative instrument is classified as equity if it does not include a contractual obligation either to deliver cash or to exchange financial instruments with another entity under potentially unfavourable conditions, and if the instrument will or may be settled by the issue of equity, settlement does not involve the issue of a variable number of shares.

*Derivatives and hedging* – under UK GAAP, non-trading derivatives are accounted for on an accruals basis in accordance with the accounting treatment of the underlying transaction or transactions being hedged. If a non-trading derivative transaction is terminated or ceases to be an effective hedge, it is re-measured at fair value and any gain or loss amortised over the remaining life of the underlying transaction or transactions being hedged. If a hedged item is derecognised the related non-trading derivative is remeasured at fair value and any gain or loss taken to the profit and loss account. Under IFRS, all derivatives are measured at fair value. Hedge accounting is permitted for three types of hedge relationship: fair value hedge – the hedge of changes in the fair value of a recognised asset or liability or firm commitment; cash flow hedge – the hedge of variability in cash flows from a recognised asset or liability or a forecast transaction; and the hedge of a net investment in a foreign operation. In a fair value hedge the gain or loss on the derivative is recognised in the profit and loss account as it arises offset by the corresponding gain or loss on the hedged item attributable to the risk hedged.

In a cash flow hedge and in the hedge of a net investment in a foreign operation, the element of the derivative’s gain or loss that is an effective hedge is recognised directly in equity. The ineffective element is taken to the profit and loss account. Certain conditions must be met for a relationship to qualify for hedge accounting. These include designation, documentation and prospective and actual hedge effectiveness.

*Embedded derivatives* – under IFRS, a derivative embedded in a contract must be accounted for separately from the host contract if the embedded derivative has economic characteristics that differ from those of the host contract. There is no equivalent requirement in UK GAAP.

*Offset* – for a financial asset and financial liability to be offset, IFRS require that an entity must intend to settle on a net basis or to realise the asset and settle the liability simultaneously. However, under UK GAAP an intention to settle net is not a requirement for set off, although the entity must have the ability to insist on net settlement and that ability is assured beyond doubt.

*Leasing*  under UK GAAP, finance lease income is recognised so as to give a level rate of return on the net cash investment in the lease. IFRS require a level rate of return on the net investment in the lease. This means that under UK GAAP tax cash flows are taken into account in allocating income but they are not under IFRS.

*Transition*  IFRS 1 First-time Adoption of International Financial Reporting Standards (IFRS 1) will apply to the Group's 2005 financial statements. The standard requires an opening IFRS balance sheet to be prepared as at the date of transition to IFRS, being the beginning of the earliest comparative period presented under IFRS in its first IFRS financial statements (the transition date). Accounting policies must comply with each IFRS effective at the reporting date of the first IFRS financial statements, and applied throughout all periods presented.

In the opening balance sheet the entity:

- recognises all assets and liabilities whose recognition is required by IFRS, but not any assets or liabilities not permitted by IFRS to be recognised;
- reclassifies items recognised under previous GAAP in accordance with IFRS requirements;
- applies IFRS in measuring all recognised assets and liabilities.

IFRS 1 provides certain optional exemptions from the above principles:

- Business combinations  past business combinations need not be restated in accordance with IFRS 3 Business Combinations.



- Fair value or revaluation as deemed cost  the fair value of an item of property, plant or equipment, or a previous GAAP revaluation (that approximates fair value) of such an item, may be treated as though it were the cost basis for the asset, with subsequent depreciation and impairment based on that amount.
- Employee benefits  under IAS 19 Employee Benefits, actuarial gains and losses on pension schemes may be unrecognised if they fall within a corridor. On first time application, an entity may determine the unrecognised gains and losses from inception of the pension scheme and recognise only those that would be recognised under IAS 19, or alternatively recognise all cumulative gains and losses at the transition date.
- Cumulative translation differences  cumulative translation differences on the net investment in a foreign operation prior to the transition date need not be calculated but set at zero.
- Compound financial instruments  split accounting required by IAS 39 need not be applied for a compound financial instrument if the liability component is no longer outstanding at the date of transition.
- Designation of financial instruments  an entity is allowed to designate a financial instrument as financial asset or financial liability at fair value through profit or loss on the date of transition rather than on initial recognition as required by IAS 39.
- Share-based payment transactions  IFRS 2 Share-based Payment must be applied to equity instruments granted on or after 7 November 2002 that had not vested before the later of the transition date and 1

January 2005.

IFRS 1 prohibits retrospective application of some aspects of IFRS:

- Derecognition of financial assets and financial liabilities  the derecognition requirements of IAS 39 are to be applied prospectively for transactions occurring on or after 1 January 2004. However, an entity is permitted to apply the derecognition requirements retrospectively from a date of its choice.

- Hedge accounting  at the transition date, all derivatives must be measured at fair value. Gains and losses deferred under previous accounting must be eliminated. Hedge accounting for relationships that do not qualify under IAS 39 must be discontinued in accordance with the hedge termination rules in IAS 39.

- Assets classified as held for sale and discontinued operations  entities with a transition date before 1 January 2005 must apply the transition rules in IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

IFRS require at least one year of comparative data. However this data need not comply with IAS 32, IAS 39 and IFRS 4 Insurance Contracts. If comparatives that do not comply with IAS 32, IAS 39 and IFRS 4 are presented, then the date of transition for these standards will be the beginning of the first IFRS reporting period.

*US GAAP*

For a discussion of recent developments in US GAAP relevant to the Group, see Note 53 on the accounts.



## **Operating and financial review** continued

**Financial highlights**

| **for the year ended 31 December** | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Total income | 22,754 | 19,281 | 17,016 |
| Profit before tax | 6,917 | 6,076 | 4,852 |
| Profit attributable to ordinary shareholders | 4,256 | 2,254 | 2,034 |
| Cost:income ratio (%) (1) | 47.7 | 49.4 | 55.6 |
| Basic earnings per share (pence) | 138.0 | 76.9 | 70.6 |
| Dividend cover (times) (2) | 2.3 | 1.5 | 1.6 |
| Return on equity (%) (3) | 16.0 | 9.8 | 8.8 |

| **at 31 December** | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Total assets | 583,467 | 454,428 | 411,038 |
| Loans and advances to customers | 345,469 | 252,531 | 223,324 |
| Deposits | 384,143 | 304,286 | 273,881 |

| | | | |
|---|---|---|---|
| Shareholders funds | 31,865 | 26,098 | 25,071 |
| Risk asset ratio  tier 1 (%) | 7.0 | 7.4 | 7.3 |
|  total (%) | 11.7 | 11.8 | 11.7 |

Notes:

(1) Cost:income ratio represents operating expenses expressed as a percentage of total income.
(2) Dividend cover represents the total ordinary dividend expressed as a multiple of profit attributable to ordinary shareholders.
(3) After-tax return on equity is based on profit attributable to ordinary shareholders and average equity shareholders funds.

* restated (see page 85)

12

**Summary consolidated profit and loss account for the year ended 31 December 2004**

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| **Net interest income** | 9,208 | 8,301 | 7,849 |
| Dividend income | 79 | 58 | 58 |
| Fees and commissions receivable | 6,634 | 5,693 | 5,249 |
| Fees and commissions payable | (1,954) | (1,337) | (965) |
| Dealing profits | 1,988 | 1,793 | 1,462 |
| Other operating income | 1,855 | 1,650 | 1,410 |
| | 8,602 | 7,857 | 7,214 |
| General insurance | | | |
|  earned premiums | 5,357 | 3,627 | 2,442 |
|  reinsurance | (413) | (504) | (489) |
| **Non-interest income** | 13,546 | 10,980 | 9,167 |
| **Total income** | 22,754 | 19,281 | 17,016 |
| **Operating expenses**** | 10,846 | 9,516 | 9,469 |
| **Profit before other operating charges** | 11,908 | 9,765 | 7,547 |
| General insurance | | | |
|  gross claims | 3,724 | 2,644 | 1,693 |
|  reinsurance | (244) | (449) | (343) |
| **Profit before provisions for bad and doubtful debts** | 8,428 | 7,570 | 6,197 |
| Provisions for bad and doubtful debts | 1,428 | 1,461 | 1,286 |
| Amounts written off fixed asset investments | 83 | 33 | 59 |

| | | | |
|---|---|---|---|
| **Profit on ordinary activities before tax** | 6,917 | 6,076 | 4,852 |
| Tax on profit on ordinary activities | 2,155 | 1,888 | 1,582 |
| **Profit on ordinary activities after tax** | 4,762 | 4,188 | 3,270 |
| Minority interests (including non-equity) | 250 | 210 | 133 |
| **Profit for the financial year** | 4,512 | 3,978 | 3,137 |
| Preference dividends – non-equity | 256 | 261 | 305 |
| | 4,256 | 3,717 | 2,832 |
| Additional Value Shares dividend – non-equity | — | 1,463 | 798 |
| **Profit attributable to ordinary shareholders** | 4,256 | 2,254 | 2,034 |
| **Basic earnings per ordinary share** | 138.0p | 76.9p | 70.6p |

* restated (see page 85)

** Integration costs included in operating expenses comprise:

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Administrative expenses | 267 | 229 | 955 |
| Depreciation | 2 | — | 2 |
| | 269 | 229 | 957 |



## Operating and financial review continued

### 2004 compared with 2003

*Profit*

Profit before tax was up 14%, from £6,076 million to £6,917 million.

The Group made a number of acquisitions during 2004 which had a bearing on the year's results. These included:

In January 2004, Ulster Bank completed the acquisition of First Active plc, for a cash consideration of €887 million.

In March 2004, RBS completed the purchase of the credit card business of People's Bank in the US.

In August 2004, Citizens completed the acquisition of Charter One Financial, Inc. for a cash consideration of US$10.1 billion.

The Group has adopted Financial Reporting Standard 17 □Retirement Benefits□ (□FRS 17□) □ the standard that replaces SSAP24 □Pension Costs□. The effect on prior years of adopting FRS 17 is shown on page 85.

*Total income*

The Group achieved strong growth in income during 2004. Total income was up 18% or £3,473 million to £22,754 million. Excluding acquisitions and at constant exchange rates, total income was up by 11%, £2,004 million.

Net interest income increased by 11% to £9,208 million and represents 40% of total income (2003 □ 43%). Excluding acquisitions and at constant exchange rates, net interest income was up 8%. Average loans and advances to customers and average customer deposits grew by 19% and 10% respectively.

Non-interest income increased by 23% to £13,546 million and represents 60% of total income (2003 □ 57%). Excluding acquisitions and at constant exchange rates, non-interest income was up 13%. There was good growth in transmission income and other fees, up 17% while general insurance premium income increased by 58%, reflecting organic growth and the acquisition of Churchill in September 2003. Gross income from rental assets grew by 18%, reflecting strong growth in operating lease assets.

*Net interest margin*

The Group's net interest margin at 2.92% was in line with expectations. Excluding the acquisition of First Active, the Group's net interest margin was down 0.03% from 2.97% in 2003, principally as a result of strong organic growth in mortgage lending and the increased funding cost of rental assets, the income from which is included in other income.

*Operating expenses*

Operating expenses rose by 14% to £10,846 million to support the strong growth in business volumes. Included in operating expenses are integration costs which in 2004 were £269 million principally relating to the integration of Churchill and the acquisitions by Citizens.

*Cost:income ratio*

The Group's ratio of operating expenses to total income improved further to 47.7% from 49.4%.

*Net insurance claims*

General insurance claims, after reinsurance, increased by 59% to £3,480 million. Excluding Churchill, the increase was 20%, consistent with volume growth and business mix.

*Provisions*

The profit and loss charge for bad and doubtful debts and amounts written off fixed asset investments was £1,511 million compared with £1,494 million in 2003. The charge for provisions in 2004 represented 0.41% of gross loans and advances to customers, compared with 0.57% in 2003.

*Credit quality*

Credit quality remains strong with no material change during 2004 in the distribution by grade of the Group's total risk assets.

The ratio of risk elements in lending to gross loans and advances to customers improved to 1.58% (2003 □ 2.01%). Risk elements in lending and potential problem loans represented 1.66% of gross loans and advances to customers (2003 □ 2.24%).

Provision coverage of risk elements in lending and potential problem loans improved to 73% (2003 □ 68%).

*Earnings and dividends*

Basic earnings per ordinary share increased by 79%, from 76.9p to 138.0p. The final dividend on the Additional Value Shares paid in December 2003 reduced earnings per ordinary share for that year by 49.9p.

A final dividend of 41.2p per ordinary share is recommended, making a total for the year of 58.0p per share, an increase of 15%. If approved, the final dividend will be paid on 3 June 2005 to shareholders registered on 11 March 2005. The total dividend is covered 2.3 times by earnings.



---

*Balance sheet*

Total assets were £583 billion at 31 December 2004, 28% higher than total assets of £454 billion at 31 December 2003.

Lending to customers, excluding repurchase agreements and stock borrowing (reverse repos), increased in 2004 by 28% or £64.8 billion to £293.3 billion. Excluding acquisitions and reverse repos, lending increased by 18%. Customer deposits, excluding repurchase agreements and stock lending (repos), grew in 2004 by 16% or £33.0 billion to £242.9 billion. Excluding acquisitions and repos, deposits increased by 7%.

Although the adoption of FRS 17 has reduced shareholders' funds by £3,220 million (2003  £2,001 million), this has no effect on the Group's regulatory capital at 31 December 2004.

Capital ratios at 31 December 2004 were 7.0% (tier 1) and 11.7% (total), against 7.4% (tier 1) and 11.8% (total) at 31 December 2003.

*Profitability*

The after-tax return on ordinary equity improved from 9.8% to 16.0%. This is based on profit attributable to ordinary shareholders and average ordinary equity.

**2003 compared with 2002**

*Profit*

Profit before tax was up 25%, from £4,852 million to £6,076 million.

*Total income*

The Group achieved strong growth in income during 2003. Total income was up 13% or £2,265 million to £19,281 million. Non-interest income accounted for 57% of total income. Excluding acquisitions, total income rose by 10%.

Net interest income increased by 6% to £8,301 million and represented 43% of total income (2002  46%). Average loans and advances to customers and average customer deposits grew by 12% and 8% respectively. The benefit of this growth more than offset the impact on net interest income of the Competition Commission inquiry into SME banking in the UK and the lower interest rate environment in the UK and the US which reduced income earned from deposits and investments.

Non-interest income increased by 20% to £10,980 million and represented 57% of total income (2002  54%). Fees receivable were up 8% with good growth in lending, transmission and card related fees reflecting higher volumes. General insurance premium income grew strongly, reflecting volume growth in both motor and home insurance products, and the acquisition of Churchill. In addition, volumes in financial markets were up strongly in both the UK and the US reflecting growth in customer-driven activity in interest rate protection, mortgage securitisation and foreign exchange. Income from rental assets grew by 17% to £1,088 million, reflecting the growth in operating leases and investment properties.

*Net interest margin*

The Group□s net interest margin at 2.97% was, in line with the first half, down from 3.13% in 2002 due to a reduced benefit from interest-free funds arising from the lower interest rate environment, and the outcome of the Competition Commission inquiry into SME banking.

*Operating expenses*

Operating expenses rose by 1% to £9,516 million. Included in operating expenses are integration costs which in 2003 were £229 million, of which, £143 million related to the final elements of the NatWest integration and £86 million related to other acquisitions, including Citizens□ acquisitions and Churchill. All integration initiatives in relation to NatWest have been implemented. The programme benefits, comprising £890 million annual revenue benefits and £1,440 million annual cost savings, were fully implemented less than three years after the acquisition of NatWest. Total costs for the integration programme were £2.3 billion. Since 6 March 2000 the integration initiatives have contributed a cumulative £5.6 billion to the Group.

*Cost:income ratio*

The strong growth in income together with tight cost management resulted in a further improvement in the Group□s ratio of operating expenses to total income, to 49.4% from 55.6%.

*Net insurance claims*

General insurance claims, after reinsurance, increased by 63% to £2,195 million. Excluding Churchill, the increase was 29%, consistent with volume growth in the component parts of the insurance division.

*Provisions*

The profit and loss charge for bad debts and amounts written off fixed asset investments was £1,494 million compared with £1,345 million in 2002. The profit and loss charge is in line with the growth in loans and advances.

*Credit quality*

There was no material change during the year in the distribution by grade of the Group□s total risk assets.

The ratio of risk elements in lending to gross loans and advances to customers at 2.01% at 31 December 2003 showed an improving trend (31 December 2002 □ 2.14%).

Risk elements in lending and potential problem loans represented 2.24% of gross loans and advances to customers compared with 2.66% at 31 December 2002.

15

---

## **Operating and financial review** continued

*Earnings and dividends*

Basic earnings per ordinary share increased by 9%, from 70.6p to 76.9p.

The final dividend of 55p per share amounting to £1.5 billion was paid on 1 December 2003 to the holders of the AVS issued in connection with the acquisition of NatWest. A total of £1 per AVS amounting to £2.7 billion in aggregate was paid over three years to shareholders in accordance with the original schedule.

The total ordinary dividend for the year was 50.3p per ordinary share an increase of 15%. The total dividend was covered 1.5 times by earnings.

*Balance sheet*

Total assets were £454 billion at 31 December 2003, 11% higher than total assets of £411 billion at 31 December 2002.

Lending to customers, excluding repurchase agreements and stock borrowing (reverse repos), increased by 13% or £27 billion to £228 billion. Customer deposits, excluding repurchase agreements and stock lending (repos), grew by 8% or £16 billion to £210 billion.

Capital ratios at 31 December 2003 were 7.4% (tier 1) and 11.8% (total), against 7.3% (tier 1) and 11.7% (total) at 31 December 2002.

*Profitability*

The after-tax return on ordinary equity was 9.8% compared with 8.8% for 2002. This is based on profit attributable to ordinary shareholders and average equity shareholders funds.

*Acquisitions*

In January 2003, Citizens completed the acquisition of Pennsylvania-based commercial bank, Commonwealth Bancorp, Inc. for a cash consideration of US$450 million.

In April 2003, Citizens announced the acquisition of Port Financial Corp., the holding company of the Massachusetts savings bank, CambridgePort Bank for a cash consideration of US$285 million. This transaction was completed on 31 July 2003.

In May 2003, RBS announced the acquisition of Nordisk Renting AB, a Swedish leasing company, for a cash consideration of €104 million. This transaction was completed on 2 June 2003.

In May 2003, RBS announced the acquisition of the credit card and personal loans portfolios of Frankfurt-based Santander Direkt Bank for a cash consideration of €486 million. This transaction was completed on 31 July 2003.

In June 2003, RBS announced the acquisition of Churchill Insurance Group PLC for a cash consideration of £1.1 billion. This transaction was completed on 1 September 2003.

In July 2003, Citizens announced the acquisition of Community Bancorp, Inc., the holding company for Community National Bank, for a cash consideration of US$116 million. This transaction was completed on 31 October 2003.

In September 2003, Citizens announced the acquisition of Thistle Group Holdings, Co., the holding company for Roxborough Manayunk Bank, for a cash consideration of US$136 million. This transaction was completed on 5 January 2004.

In October 2003, Coutts Bank (Switzerland) Limited announced the acquisition of a Swiss private bank, Bank von Ernst & Cie AG, for a cash consideration of Swiss Francs 500 million. This transaction was completed on 28 November 2003.

In October 2003, RBS announced that it had agreed terms for a recommended acquisition of First Active plc, for a cash consideration of €887 million. This transaction was completed on 5 January 2004.

On 3 February 2004, RBS announced that it had agreed terms with Peoples Bank of Connecticut to purchase their credit card portfolio. This transaction was completed on 5 March 2004.

*Disposals*

In May 2003, RBS announced the sale of the Miami-based Latin American private banking operations of Coutts Group to Santander Central Hispano. The cash consideration was US$81 million. This transaction was completed on 31 July 2003.



**Analysis of results**

| **Net interest income** | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Interest receivable | 16,696 | 13,998 | 13,561 |
| Interest payable | (7,488) | (5,697) | (5,712) |
| Net interest income | 9,208 | 8,301 | 7,849 |

| | % | % | % |
|---|---|---|---|
| Gross yield on interest-earning assets of the banking business | 5.30 | 5.00 | 5.41 |
| Cost of interest-bearing liabilities of the banking business | (2.70) | (2.32) | (2.70) |
| Interest spread of the banking business | 2.60 | 2.68 | 2.71 |
| Benefit from interest-free funds | 0.32 | 0.29 | 0.42 |
| Net interest margin of the banking business | 2.92 | 2.97 | 3.13 |

| Yields, spreads and margins of the banking business | % | % | % |
|---|---|---|---|
| Gross yield | | | |
| Group | 5.30 | 5.00 | 5.41 |
| UK | 5.70 | 5.20 | 5.56 |
| Overseas | 4.38 | 4.44 | 4.97 |
| Interest spread | | | |
| Group | 2.60 | 2.68 | 2.71 |
| UK | 2.68 | 2.68 | 2.72 |
| Overseas | 2.48 | 2.71 | 2.69 |
| Net interest margin | | | |
| Group | 2.92 | 2.97 | 3.13 |
| UK | 2.96 | 2.95 | 3.14 |
| Overseas | 2.83 | 3.02 | 3.09 |
| The Royal Bank of Scotland plc base rate | 4.38 | 3.69 | 4.00 |
| London inter-bank three month offered rates: | | | |
| Sterling | 4.64 | 3.74 | 4.06 |
| Eurodollar | 1.62 | 1.22 | 1.80 |
| Euro | 2.11 | 2.33 | 3.32 |

Notes:

(1) Gross yield is the interest rate earned on average interest-earning assets of the banking business.
(2) Interest spread is the difference between the gross yield and the interest rate paid on average interest-bearing liabilities of the banking business.
(3) Net interest margin is net interest income of the banking business as a percentage of average interest-earning assets of the banking business.

*2004 compared with 2003*

Group  The net interest margin decreased from 2.97% to 2.92%. The interest spread declined reflecting principally a change in mix towards relatively lower margin mortgage business including the acquisition of First Active. This was partially offset by an increase in the benefit from interest-free funds due to increased volumes and movements in interest rates.

UK  The UK net interest margin increased slightly from 2.95% to 2.96%. An increase in the benefit from interest-free funds, due to movements in interest rates, and improvements in corporate lending margins were largely offset by growth in the mortgage business.

Overseas  The Overseas net interest margin decreased from 3.02% to 2.83%. This reduction reflected the continued tightening of asset spreads in the US, together with the growth in mortgage business following the acquisition of First Active. Higher volumes together with movements in interest rates led to an increase in the benefit of interest-free funds.

*2003 compared with 2002*

Net interest income increased by 6%, £452 million, to £8,301 million. Average interest-earning assets of the Groups banking business increased by 12%, £29.1 billion, to £279.7 billion. Within this, average loans and advances to customers were up 12%, £23.3 billion, to £213.3 billion due to growth in both corporate and personal lending.

Interest spread for the Group as a whole decreased from 2.71% to 2.68%. Interest-free balances fell partly due to the outcome of the Competition Commission inquiry into SME banking. This, together with the lower interest rate environment contributed to the reduction in the benefit of interest-free funds from 0.42% to 0.29% giving a decline in net interest margin from 3.13% to 2.97%.

UK  Interest spread decreased from 2.72% to 2.68% with product margins remaining stable despite growth in the relatively lower margin mortgage business. The reduced benefit of interest-free funds due to the rate and volume impact described above resulted in the decrease in net interest margin from 3.14% to 2.95%.

Overseas  Interest spread increased from 2.69% to 2.71%. Asset spreads tightened in the US due to lower interest rates; however, this was more than offset by overall mix and volume improvements elsewhere. Lower interest rates led to a reduction in the benefit from interest-free funds, resulting in the decline in net interest margin from 3.09% to 3.02%.



## **Operating and financial review** continued

### Average balance sheet and related interest

| | 2004 | 2003* |
|---|---|---|

| | Average balance £m | Interest £m | Rate % | Average balance £m | Interest £m | Rate % |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Treasury and other eligible bills — UK | 835 | 34 | 4.07 | 1,378 | 48 | 3.48 |
| — Overseas | 62 | 1 | 1.61 | 64 | 1 | 1.56 |
| Loans and advances to banks — UK | 13,528 | 527 | 3.90 | 13,724 | 459 | 3.34 |
| — Overseas | 9,189 | 264 | 2.87 | 9,559 | 212 | 2.22 |
| Loans and advances to customers — UK | 184,837 | 11,152 | 6.03 | 168,390 | 9,519 | 5.65 |
| — Overseas | 69,118 | 3,201 | 4.63 | 44,862 | 2,240 | 4.99 |
| Debt securities — UK | 19,549 | 756 | 3.87 | 23,810 | 754 | 3.17 |
| — Overseas | 18,132 | 761 | 4.20 | 17,927 | 765 | 4.27 |
| **Total interest-earning assets — banking business** | 315,250 | 16,696 | 5.30 | 279,714 | 13,998 | 5.00 |
| — trading business (3) | 133,353 | | | 96,648 | | |
| Total interest-earning assets | 448,603 | | | 376,362 | | |
| Non-interest-earning assets | 70,510 | | | 66,060 | | |
| **Total assets** | 519,113 | | | 442,422 | | |
| Percentage of assets applicable to overseas operations | 33.1% | | | 32.4% | | |
| **Liabilities and shareholders' equity** | | | | | | |
| Deposits by banks — UK | 35,059 | 1,060 | 3.02 | 28,220 | 703 | 2.49 |
| — Overseas | 16,425 | 398 | 2.42 | 9,565 | 218 | 2.28 |
| Customer accounts: demand deposits — UK | 67,519 | 1,569 | 2.32 | 64,469 | 1,028 | 1.59 |
| — Overseas | 11,580 | 147 | 1.27 | 9,166 | 70 | 0.76 |
| Customer accounts: savings deposits — UK | 24,147 | 673 | 2.79 | 18,653 | 503 | 2.70 |
| — Overseas | 18,349 | 252 | 1.37 | 16,310 | 260 | 1.59 |
| Customer accounts: other time deposits — UK | 51,591 | 1,712 | 3.32 | 49,880 | 1,478 | 2.96 |
| — Overseas | 20,725 | 479 | 2.31 | 16,642 | 374 | 2.25 |
| Debt securities in issue — UK | 37,097 | 1,229 | 3.31 | 29,977 | 914 | 3.05 |
| — Overseas | 12,320 | 229 | 1.86 | 9,630 | 119 | 1.24 |
| Loan capital — UK | 17,959 | 665 | 3.70 | 15,342 | 534 | 3.48 |
| — Overseas | 235 | 15 | 6.38 | 154 | 16 | 10.39 |
| Internal funding of trading business — UK | (35,317) | (920) | 2.60 | (21,258) | (497) | 2.34 |
| — Overseas | (758) | (20) | 2.64 | (1,651) | (23) | 1.39 |
| **Total interest-bearing liabilities — banking business** | 276,931 | 7,488 | 2.70 | 245,099 | 5,697 | 2.32 |
| — trading business (3) | 131,743 | | | 93,466 | | |

| | | |
|---|---|---|
| Total interest-bearing liabilities | 408,674 | 338,565 |
| Non-interest-bearing liabilities | | |
| Demand deposits — UK | 17,765 | 17,589 |
| — Overseas | 9,101 | 7,330 |
| Other liabilities | 53,726 | 52,810 |
| Shareholders’ funds — equity | 26,538 | 22,973 |
| — non-equity | 3,309 | 3,155 |
| **Total liabilities and shareholders’ equity** | 519,113 | 442,422 |
| Percentage of liabilities applicable to overseas operations | 30.6% | 30.6% |

* restated (see page 85)

Notes:
(1) The analysis into UK and Overseas has been compiled on the basis of location of office.
(2) Loans and advances to customers include non-accrual loans. Interest income includes income on non-accruing loans only to the extent cash payments have been received.
(3) Interest receivable and interest payable on trading assets and liabilities are included in dealing profits.



| | 2002* | | |
|---|---|---|---|
| | Average balance £m | Interest £m | Rate % |
| **Assets** | | | |
| Treasury and other eligible bills — UK | 910 | 24 | 2.64 |
| — Overseas | 351 | 6 | 1.71 |
| Loans and advances to banks — UK | 13,439 | 532 | 3.96 |
| — Overseas | 9,811 | 304 | 3.10 |
| Loans and advances to customers — UK | 154,202 | 9,141 | 5.93 |
| — Overseas | 35,759 | 1,963 | 5.49 |
| Debt securities — UK | 17,950 | 675 | 3.76 |
| — Overseas | 18,188 | 916 | 5.04 |
| **Total interest-earning assets — banking business** | 250,610 | 13,561 | 5.41 |
| — trading business (3) | 78,380 | | |
| Total interest-earning assets | 328,990 | | |
| Non-interest-earning assets | 64,867 | | |
| **Total assets** | 393,857 | | |

| | | | |
|---|---|---|---|
| Percentage of assets applicable to overseas operations | 32.0% | | |
| **Liabilities and shareholders’ equity** | | | |
| Deposits by banks – UK | 21,090 | 544 | 2.58 |
| – Overseas | 9,058 | 215 | 2.37 |
| Customer accounts: demand deposits – UK | 58,618 | 1,062 | 1.81 |
| – Overseas | 8,275 | 99 | 1.20 |
| Customer accounts: savings deposits – UK | 16,002 | 463 | 2.89 |
| – Overseas | 11,742 | 229 | 1.95 |
| Customer accounts: other time deposits – UK | 45,902 | 1,542 | 3.36 |
| – Overseas | 16,264 | 462 | 2.84 |
| Debt securities in issue – UK | 24,154 | 965 | 4.00 |
| – Overseas | 8,693 | 209 | 2.40 |
| Loan capital – UK | 13,154 | 640 | 4.87 |
| – Overseas | 166 | 17 | 10.24 |
| Internal funding of trading business – UK | (20,129) | (709) | 3.52 |
| – Overseas | (1,301) | (26) | 2.00 |
| **Total interest-bearing liabilities – banking business** | 211,688 | 5,712 | 2.70 |
| – trading business (3) | 75,059 | | |
| Total interest-bearing liabilities | 286,747 | | |
| Non-interest-bearing liabilities | | | |
| Demand deposits – UK | 21,848 | | |
| – Overseas | 6,401 | | |
| Other liabilities | 52,047 | | |
| Shareholders’ funds – equity | 23,075 | | |
| – non-equity | 3,739 | | |
| **Total liabilities and shareholders’ equity** | 393,857 | | |
| Percentage of liabilities applicable to overseas operations | 30.4% | | |

* restated (see page 85)

Notes:

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

(2) Loans and advances to customers include non-accrual loans. Interest income includes income on non-accruing loans only to the extent cash payments have been received.

(3) Interest receivable and interest payable on trading assets and liabilities are included in dealing profits.

**Analysis of change in net interest income — volume and rate analysis**

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

| | 2004 over 2003 | | | 2003 over 2002 | | |
|---|---|---|---|---|---|---|
| | Increase/(decrease) due to changes in: | | | Increase/(decrease) due to changes in: | | |
| | Average volume £m | Average rate £m | Net change £m | Average volume £m | Average rate £m | Net change £m |
| **Interest-earning assets** | | | | | | |
| Treasury and other eligible bills | | | | | | |
| UK | (21) | 7 | (14) | 15 | 9 | 24 |
| Overseas | — | — | — | (5) | — | (5) |
| Loans and advances to banks | | | | | | |
| UK | (7) | 75 | 68 | 11 | (84) | (73) |
| Overseas | (8) | 60 | 52 | (8) | (84) | (92) |
| Loans and advances to customers | | | | | | |
| UK | 967 | 666 | 1,633 | 820 | (442) | 378 |
| Overseas | 1,133 | (172) | 961 | 467 | (190) | 277 |
| Debt securities | | | | | | |
| UK | (148) | 150 | 2 | 196 | (117) | 79 |
| Overseas | 9 | (13) | (4) | (13) | (138) | (151) |
| Total interest receivable of the banking business | | | | | | |
| UK | 791 | 898 | 1,689 | 1,042 | (634) | 408 |
| Overseas | 1,134 | (125) | 1,009 | 441 | (412) | 29 |
| | 1,925 | 773 | 2,698 | 1,483 | (1,046) | 437 |
| **Interest-bearing liabilities** | | | | | | |
| Deposits by banks | | | | | | |
| UK | (190) | (167) | (357) | (179) | 20 | (159) |
| Overseas | (166) | (14) | (180) | (12) | 9 | (3) |
| Customer accounts: demand deposits | | | | | | |
| UK | (51) | (490) | (541) | (101) | 135 | 34 |
| Overseas | (22) | (55) | (77) | (10) | 39 | 29 |
| Customer accounts: savings deposits | | | | | | |
| UK | (153) | (17) | (170) | (72) | 32 | (40) |
| Overseas | (30) | 38 | 8 | (78) | 47 | (31) |
| Customer accounts: other time deposits | | | | | | |
| UK | (51) | (183) | (234) | (128) | 192 | 64 |
| Overseas | (95) | (10) | (105) | (10) | 98 | 88 |
| Debt securities in issue | | | | | | |
| UK | (232) | (83) | (315) | (205) | 256 | 51 |
| Overseas | (39) | (71) | (110) | (20) | 110 | 90 |
| Loan capital | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| UK | (96) | (35) | (131) | (96) | 202 | 106 |
| Overseas | (7) | 8 | 1 | 1 | □□ | 1 |
| Internal funding of trading business | | | | | | |
| UK | 362 | 61 | 423 | 38 | (250) | (212) |
| Overseas | (17) | 14 | (3) | 6 | (9) | (3) |
| Total interest payable of the banking business | | | | | | |
| UK | (411) | (914) | (1,325) | (743) | 587 | (156) |
| Overseas | (376) | (90) | (466) | (123) | 294 | 171 |
| | (787) | (1,004) | (1,791) | (866) | 881 | 15 |
| Movement in net interest income | | | | | | |
| UK | 380 | (16) | 364 | 299 | (47) | 252 |
| Overseas | 758 | (215) | 543 | 318 | (118) | 200 |
| | 1,138 | (231) | 907 | 617 | (165) | 452 |



| Non-interest income | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Dividend income | 79 | 58 | 58 |
| Fees and commissions receivable | 6,634 | 5,693 | 5,249 |
| Fees and commissions payable | (1,954) | (1,337) | (965) |
| Dealing profits | 1,988 | 1,793 | 1,462 |
| Other operating income | 1,855 | 1,650 | 1,410 |
| | 8,602 | 7,857 | 7,214 |
| General insurance premium income | | | |
| Earned premiums | 5,357 | 3,627 | 2,442 |
| Reinsurance | (413) | (504) | (489) |
| | 4,944 | 3,123 | 1,953 |
| | 13,546 | 10,980 | 9,167 |

Note:
* FRS 17 restatements are detailed on page 85. In addition, certain income has been re-classified from net fees and commissions to insurance premium income in order to conform the accounting policies of Direct Line and Churchill.

*2004 compared with 2003*

Non-interest income increased by £2,566 million, 23% to £13,546 million and represents 60% of total income (2003 57%). Excluding acquisitions and at constant exchange rates, non-interest income was up 13%.

Within non-interest income, fees and commissions receivable increased by 17% or £941 million, to £6,634 million. This reflected strong growth in lending, transmission and card related fees together with increased insurance brokerage and ATM income.

Fees and commissions payable increased by £617 million to £1,954 million reflecting higher brokerage costs in CBFM due to greater volumes of trading and structuring business and fees paid in Retail Direct in support of higher volumes. Commissions payable to brokers and intermediaries in the general insurance business were up reflecting the acquisition of Churchill in September 2003.

Dealing profits at £1,988 million were up £195 million, 11% on 2003. Growth was achieved across all customer segments and product classes with further diversification of dealing revenues in the US to compensate for lower residential refinancing volume than the previous year.

Other operating income increased by 12% to £1,855 million. This was principally due to higher gross income from rental assets reflecting strong growth in operating lease assets.

General insurance premium income, after reinsurance, rose by 58%, or £1,821 million to £4,944 million reflecting organic growth and the acquisition of Churchill. Excluding Churchill, the growth was 17% reflecting volume growth in motor and home insurance products.

*2003 compared with 2002*

Non-interest income increased by 20%, or £1,813 million, to £10,980 million. Non-interest income represented 57% of total income. Excluding general insurance premium income, non-interest income rose by 9% or £643 million to £7,857 million reflecting strong performances in CBFM, up 18% or £670 million and Retail Direct, up 17%, or £145 million.

Within non-interest income, fees and commissions receivable increased by 8% or £444 million, to £5,693 million. This reflected an increase in lending and transmission fees, and good growth in insurance brokerage, cards related fees and ATM income.

Fees and commissions payable increased by £372 million to £1,337 million reflecting higher brokerage costs in CBFM, fees paid in Retail Direct in support of higher volumes and commissions payable to brokers and intermediaries following the acquisition of Churchill.

Dealing profits at £1,793 million were up £331 million, 23% on 2002. This reflected strong growth in volumes in all product areas. The performance in the first half of the year benefited from the unusually high levels of demand for mortgage backed securities in the US.

Other operating income increased by 17% to £1,650 million. This was due to growth in income from rental assets (comprising operating lease assets and investment properties) and higher investment securities gains.

General insurance premium income, after reinsurance, rose by 60%, or £1,170 million to £3,123 million. Excluding the acquisition of Churchill Insurance the growth was 25% or £490 million reflecting volume growth in motor and home insurance products.

## **Operating and financial review** continued

### Operating expenses*

| | 2004 £m | 2003** £m | 2002** £m |
|---|---|---|---|
| Administrative expenses: | | | |
| Staff costs | 5,344 | 4,653 | 4,584 |
| Premises and equipment | 1,184 | 1,073 | 1,006 |
| Other administrative | 2,296 | 2,108 | 2,253 |
| Total administrative expenses | 8,824 | 7,834 | 7,843 |
| Depreciation and amortisation | 2,022 | 1,682 | 1,626 |
| | 10,846 | 9,516 | 9,469 |

* includes integration costs (see page 23)

** restated (see page 85)

*2004 compared with 2003*

Operating expenses rose by 14% to £10,846 million to support the strong growth in business volumes.

Staff costs were up £691 million, 15% to £5,344 million reflecting acquisitions, business growth and higher pension costs following the implementation of FRS 17. The number of staff increased by 15,700, 13% to 136,600. Of the increase 10,500 was due to acquisitions.

Premises and equipment expenses increased by £111 million, 10% to £1,184 million reflecting investment to upgrade the property portfolio in major UK centres to support the core business.

The increase in other administrative expenses reflected business volume growth and continued expenditure in support of Group wide projects.

The Group's ratio of operating expenses to total income improved further to 47.7% from 49.4%.

*2003 compared with 2002*

Operating expenses rose by 1% or £47 million to £9,516 million. This increased expenditure was in support of strong organic growth and customer service improvements.

Staff costs were up £69 million, to £4,653 million reflecting acquisitions and business growth. The number of staff increased by 9,100, 8% to 120,900. Acquisitions in the year added 9,700 staff of which 8,500 related to Churchill.

Premises and equipment expenses increased by £67 million, 7% to £1,073 million reflecting the continuing upgrade of the property portfolio in major UK centres to support the core business.

The increase in other administrative expenses reflected higher business volumes and included expenditure in support of Group wide projects.

Continued income growth coupled with a rigorous approach to cost management further improved the Group's cost:income ratio, to 49.4% from 55.6%.

**Integration costs (included in operating expenses)**

| | 2004<br>£m | 2003<br>£m | 2002<br>£m |
|---|---|---|---|
| Staff costs | 113 | 125 | 530 |
| Premises and equipment | 34 | 31 | 127 |
| Other administrative expenses | 120 | 73 | 298 |
| Depreciation of tangible fixed assets | 2 | – | 2 |
| | 269 | 229 | 957 |

Integration costs in 2004 comprise £87 million relating to the integration of Churchill, £91 million relating to the integration of Charter One and £91 million in respect of other acquisitions.

Integration costs in 2003 comprise £143 million relating to the integration of NatWest, £63 million relating to the integration of Citizens' acquisitions and £23 million in respect of other acquisitions.

Integration costs in 2002 comprise £810 million relating to the integration of NatWest and £147 million relating to the integration of Citizens' acquisitions.

Accruals in relation to integration costs are set out below.

| | At 31 December 2003<br>£m | Currency translation adjustments<br>£m | Charge to profit and loss account<br>£m | Utilised during the year<br>£m | At 31 December 2004<br>£m |
|---|---|---|---|---|---|
| Staff costs – redundancy | 19 | – | 19 | (27) | 11 |
| Staff costs – other | 27 | (1) | 94 | (91) | 29 |
| Premises and equipment | 2 | (1) | 34 | (22) | 13 |
| Other | 33 | (2) | 122 | (109) | 44 |
| | 81 | (4) | 269 | (249) | 97 |



## **Operating and financial review** continued

**Provisions**

| | 2004<br>£m | 2003<br>£m | 2002<br>£m |
|---|---|---|---|

| | | | |
|---|---|---|---|
| New provisions | 1,658 | 1,566 | 1,408 |
| less: recoveries of amounts previously written off | (147) | (72) | (63) |
| Charge to profit and loss account | 1,511 | 1,494 | 1,345 |
| Comprising: | | | |
| Provisions for bad and doubtful debts | 1,428 | 1,461 | 1,286 |
| Amounts written off fixed asset investments | 83 | 33 | 59 |
| Charge to profit and loss account | 1,511 | 1,494 | 1,345 |

*2004 compared with 2003*

New provisions were up 6%, £92 million to £1,658 million. Recoveries of amounts previously written more than doubled to £147 million. Consequently the net charge to the profit and loss account was up £17 million, 1% to £1,511 million.

Bad debt provisions amounted to £1,428 million compared with £1,461 million in 2003, a decrease of 2%. Amounts written off fixed asset investments were up from £33 million in 2003 to £83 million.

Total balance sheet provisions for bad and doubtful debts amounted to £4,228 million compared with £3,929 million at 31 December 2003. Total provision coverage (the ratio of total balance sheet provisions to total risk elements in lending) remained stable at 76%.

The ratio of total balance sheet provisions to total risk elements in lending and potential problem loans increased to 73% compared with 68% at 31 December 2003.

*2003 compared with 2002*

New provisions were up 11%, £158 million to £1,566 million. Recoveries of amounts previously written off were up £9 million, 14%, to £72 million. Consequently the net charge to the profit and loss account was up £149 million, 11% to £1,494 million.

Bad debt provisions amounted to £1,461 million compared with £1,286 million in 2002, an increase of 14%. The increased charge was in line with the growth in lending during 2003. Amounts written off fixed asset investments, largely in the second half of the year, were down £26 million to £33 million compared with £59 million in 2002.

Total balance sheet provisions for bad and doubtful debts amounted to £3,929 million compared with £3,927 million at 31 December 2002. Total provision coverage (the ratio of total balance sheet provisions to total risk elements in lending) was 76% compared with 80% at 31 December 2002.

The ratio of total balance sheet provisions to total risk elements in lending and potential problem loans increased to 68% compared with 65% at 31 December 2002.

**Taxation**

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Tax on profit on ordinary activities | 2,155 | 1,888 | 1,582 |
| | % | % | % |
| UK corporation tax rate | 30.0 | 30.0 | 30.0 |

| | | | |
|---|---|---|---|
| Effective tax rate | 31.2 | 31.1 | 32.6 |

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

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Expected tax charge | 2,075 | 1,823 | 1,456 |
| Goodwill amortisation | 241 | 200 | 183 |
| Contributions to employee share schemes | (32) | (35) | (40) |
| Non-deductible items | 227 | 248 | 179 |
| Non-taxable items | (251) | (207) | (188) |
| Capital allowances in excess of depreciation | (415) | (626) | (340) |
| Other | 45 | 16 | 6 |
| Adjustments in respect of prior periods | (168) | (77) | (15) |
| Current tax charge for year | 1,722 | 1,342 | 1,241 |
| Deferred taxation: | | | |
| Origination and reversal of timing differences | 482 | 581 | 397 |
| Adjustments in respect of prior periods | (49) | (35) | (56) |
| Actual tax charge | 2,155 | 1,888 | 1,582 |

* restated (see page 85)



**Divisional performance**

The contribution of each division before goodwill amortisation and integration costs and, where appropriate, Manufacturing costs is detailed below.

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Corporate Banking and Financial Markets | 4,265 | 3,620 | 3,261 |
| Retail Banking* | 3,279 | 3,170 | 3,074 |
| Retail Direct* | 1,040 | 881 | 708 |
| Manufacturing* | (2,439) | (2,114) | (1,952) |
| Wealth Management* | 468 | 402 | 407 |
| RBS Insurance* | 862 | 609 | 456 |
| Ulster Bank* | 468 | 354 | 318 |
| Citizens | 1,037 | 857 | 766 |
| Central items** | (879) | (711) | (498) |
| Profit before goodwill amortisation and integration costs | 8,101 | 7,068 | 6,540 |
| Goodwill amortisation | 915 | 763 | 731 |
| Integration costs | 269 | 229 | 957 |

| | | | |
|---|---|---|---|
| **Profit on ordinary activities before tax** | 6,917 | 6,076 | 4,852 |

* prior periods have been restated to reflect the transfer in 2004 of certain activities from Wealth Management to Retail Banking and from other divisions, principally RBS Insurance and Ulster Bank, to Manufacturing.
** restated following the implementation of FRS 17

The performance of each of the divisions is reviewed on pages 26 to 37.



## **Operating and financial review** continued

### Corporate Banking and Financial Markets

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Net interest income excluding funding cost of rental assets | 2,959 | 2,653 | 2,631 |
| Funding cost of rental assets | (414) | (329) | (282) |
| Net interest income | 2,545 | 2,324 | 2,349 |
| Fees and commissions receivable | 1,723 | 1,537 | 1,394 |
| Fees and commissions payable | (277) | (220) | (157) |
| Dealing profits (before associated direct costs) | 1,855 | 1,661 | 1,338 |
| Income on rental assets | 1,282 | 1,088 | 931 |
| Other operating income | 381 | 307 | 197 |
| Non-interest income | 4,964 | 4,373 | 3,703 |
| **Total income** | 7,509 | 6,697 | 6,052 |
| Direct expenses | | | |
|  staff costs | 1,642 | 1,410 | 1,230 |
|  other | 412 | 394 | 375 |
|  operating lease depreciation | 610 | 518 | 461 |
| | 2,664 | 2,322 | 2,066 |
| Contribution before provisions | 4,845 | 4,375 | 3,986 |
| Provisions | 580 | 755 | 725 |
| **Contribution** | 4,265 | 3,620 | 3,261 |

| | £bn | £bn | £bn |
|---|---|---|---|
| Total assets* | 265.3 | 219.0 | 203.4 |

| | | | |
|---|---|---|---|
| Loans and advances to customers  gross* | | | |
|  banking book | 114.9 | 99.3 | 92.1 |
|  trading book | 10.0 | 5.0 | 3.6 |
| Rental assets | 11.2 | 10.1 | 7.0 |
| Customer deposits* | 74.9 | 68.6 | 62.2 |
| Weighted risk assets  banking | 160.9 | 140.0 | 125.2 |
|  trading | 16.9 | 12.6 | 11.3 |

*excluding repos and reverse repos

*2004 compared with 2003*

Contribution increased by 18%, £645 million to £4,265 million reflecting growth in all business areas.

Total income was up 12% or £812 million to £7,509 million. Strong growth in all locations was partially masked by the effect of stronger sterling on the translation of income from Europe and North American businesses. At constant exchange rates, income grew by 14% and contribution was up 20%.

Net interest income, excluding the cost of funding rental assets, increased 12% or £306 million to £2,959 million. Average loans and advances to customers of the banking business increased by 10% or £9.5 billion to £103.8 billion. The second half of 2004 saw a modest recovery in large corporate lending. Average customer deposits within the banking business increased by 8% or £5.0 billion to £66.0 billion. An improvement in margins was achieved through strong growth in our UK mid-corporate relationships.

Fees receivable rose by £186 million, 12% to £1,723 million with growth driven by lending, structured finance and capital markets activities. Fees payable, including brokerage, were up £57 million to £277 million due to the greater volumes of trading and structuring business.

Dealing profits, which is income (before associated direct costs) arising from our role in providing customers with debt and risk management products in interest rate, currency and credit asset classes, rose by 12% to £1,855 million. Growth was achieved across all our customer segments and product classes with further diversification of dealing revenues in the US to compensate for lower residential mortgage refinancing volume than in 2003. The Group's trading value-at-risk (VaR) remains modest and the average VaR was £10.8 million (2003  £9.4 million).

The asset rental business, comprising operating lease assets and investment properties continued to grow strongly. Rental assets increased to £11.2 billion and income after deducting funding costs and operating lease depreciation increased by 7%, £17 million to £258 million.

Other operating income also grew strongly, up £74 million or 24% to £381 million.

Direct expenses increased by 15% or £342 million to £2,664 million. Excluding operating lease depreciation, operating expenses were up 14%, £250 million. This was mainly due to the mix effect of faster growth in businesses with inherently higher cost:income ratios, such as Capital Markets and our overseas businesses, together with the investment in new revenue initiatives in the US.

The charge for provisions for bad debts and amounts written off fixed asset investments amounted to £580 million, a decrease of 23%, £175 million. The reduction reflects an improvement in corporate credit quality and the economic environment in 2004.



*2003 compared with 2002*

Contribution increased by 11% or £359 million to £3,620 million. As well as in the UK, the division also achieved good growth in Europe and North America.

Total income was up 11% or £645 million to £6,697 million with strong growth across all business areas.

Average loans and advances to customers of the banking business increased by 9% or £7.5 billion to £94.3 billion. Lending margin was maintained. Average customer deposits within the banking businesses increased by 7% or £4.1 billion to £61.0 billion; however, the lower interest rate environment adversely affected deposit margins as it reduced the benefit of interest free funds. Net interest income was further impacted by the effect of implementing from 1 January 2003 the pricing remedies agreed following the Competition Commission inquiry into SME banking and by lower money market income, due to less favourable market conditions.

The asset rental business comprising operating leases and investment properties, grew strongly. Rental assets increased to £10.1 billion and net income after deducting funding costs and operating lease depreciation increased by 28%, £53 million to £241 million.

Fees receivable rose by £143 million, 10% to £1,537 million due to growth in fees related to lending and from the expansion and success of capital markets activities. Fees payable including brokerage were up £63 million to £220 million due to higher volumes in Financial Markets.

Dealing profits which is income (before associated direct costs) arising from our role in providing customers with debt and risk management products in interest rate, currency and credit asset classes, rose by 24% to £1,661 million providing incremental profit contribution of some £170 million. There was steady growth in underlying customer volumes in all product areas. While first half performance was particularly strong given the unusually high levels of demand for mortgage backed securities in the United States, dealing revenues in the second half were up 10% on the prior year period, in line with the growth in income for the division as a whole.

Other operating income was up £110 million, 56% to £307 million partially due to the full year effect of the inclusion of Dixon Motors gross profit.

Direct expenses increased by 12% or £256 million to £2,322 million. Excluding the effect of the acquisition of Nordisk Renting and Dixon Motors and operating lease depreciation, operating expenses were up 10%, £161 million. This was due to performance related costs associated with the strong growth in trading revenues, expansion in all business areas and continued investment in capital market activities and in the growing overseas franchise.

The charge for provisions for bad debts and amounts written off fixed asset investments amounted to £755 million, an increase of £30 million. The charge in the second half of the year was £351 million, 13% lower than the first half. The increase in provisions of 4% over last year was less than the growth in lending of 9%, reflecting an improvement in credit quality and the economic environment during 2003.



---

## **Operating and financial review** continued

### Retail Banking

| | 2004<br>£m | 2003*<br>£m | 2002*<br>£m |
|---|---|---|---|
| Net interest income | 3,112 | 2,959 | 2,849 |
| Non-interest income | 1,630 | 1,514 | 1,430 |

| | | | |
|---|---|---|---|
| **Total income** | 4,742 | 4,473 | 4,279 |
| Direct expenses | | | |
|  staff costs | 834 | 793 | 729 |
|  other | 240 | 237 | 263 |
| | 1,074 | 1,030 | 992 |
| Contribution before provisions | 3,668 | 3,443 | 3,287 |
| Provisions | 389 | 273 | 213 |
| **Contribution** | 3,279 | 3,170 | 3,074 |

| | £bn | £bn | £bn |
|---|---|---|---|
| Total banking assets | 74.2 | 63.9 | 57.4 |
| Loans and advances to customers  gross | | | |
|  mortgages | 44.1 | 36.6 | 32.1 |
|  small business | 15.2 | 13.8 | 12.5 |
|  consumer lending | 12.9 | 11.4 | 11.0 |
| Customer deposits | 70.6 | 66.5 | 61.9 |
| Weighted risk assets | 49.7 | 42.9 | 38.8 |

* prior periods have been restated to reflect the transfer in 2004 of certain activities from Wealth Management.

*2004 compared with 2003*

The division continued to achieve strong volume growth across all key product areas  in particular mortgages, loans and savings  supported by increased customer numbers. As a result, income increased by 6% or £269 million to £4,742 million, and contribution by 3% or £109 million to £3,279 million.

Net interest income rose by 5% or £153 million to £3,112 million, reflecting strong growth in lending and deposits which more than offset the impact of business mix  particularly strong growth in low risk mortgage lending  and the impact of lower margin in some areas, especially unsecured lending. Average loans to customers, excluding mortgages, grew by 12% or £2.8 billion to £26.5 billion. Average mortgage lending grew by 21% or £7.0 billion to £40.7 billion. Both mortgage and non-mortgage lending have evidenced a slowdown in growth in the second half of the year. Average customer deposits increased by 8% or £4.9 billion to £66.0 billion.

Non-interest income rose by 8% or £116 million to £1,630 million. This reflected higher fee income associated with strong asset growth in both personal and business sectors together with increased volumes of money transmission activity.

Direct expenses increased by 4% or £44 million to £1,074 million. Staff expenses increased 5% or £41 million to £834 million, principally due to the deployment of an additional one thousand customer facing staff in the NatWest network. The increase in other expenses was 1% or £3 million, reflecting rigorous cost management.

The charge for provisions for bad and doubtful debts increased by £116 million to £389 million. The increased charge reflects the anticipated increase in delinquency rates in the NatWest portfolio following growth in unsecured lending in recent years. NatWest credit experience is now broadly consistent with the RBS portfolio which has been stable for a number of years. As reported in the first half, there has also been a higher incidence of fraud which has led to some deterioration in recovery rates.

The overall quality of the loan portfolio, the majority of which is mortgage lending, as measured by probability of default, remained in line with expectations.



*2003 compared with 2002*

The division achieved strong volume growth across all personal product areas - current accounts, mortgages and loans and savings. Despite lower interest rates and the adverse effect of the pricing remedies agreed following the Competition Commission inquiry into SME banking which were implemented from 1 January 2003, income increased by 5% or £194 million to £4,473 million, and contribution by 3% or £96 million to £3,170 million.

Net interest income rose by 4% or £110 million to £2,959 million, reflecting the continued strong growth in customer advances and deposits which was partially offset by the implementation of the Competition Commission pricing remedies and the impact of a lower interest rate environment. Excluding the effect of the Competition Commission the increase was 8%. Average loans to customers, excluding mortgages, grew by 9% or £1.9 billion to £23.7 billion. Average mortgage lending grew by 12% or £3.6 billion to £33.7 billion. Average customer deposits increased by 6% or £3.7 billion to £60.9 billion.

Non-interest income rose by 6% or £84 million to £1,514 million. This reflected further growth in the customer base and a 15% growth in general insurance income to £301 million. Embedded value profits of the life assurance business increased by 14%, or £7 million to £57 million.

Direct expenses increased by 4% or £38 million to £1,030 million. Staff expenses increased 9% or £64 million to £793 million reflecting further investment in customer facing staff.

Other expenses decreased 10% or £26 million to £237 million, as a result of our rigorous approach to management of non-staff costs.

The charge for provisions for bad debts increased by £60 million to £273 million. The overall quality of the loan portfolio remained stable and the increased charge reflected growth in lending over recent years particularly in NatWest since its acquisition.



## **Operating and financial review** continued

**Retail Direct**

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Net interest income | 938 | 849 | 749 |
| Non-interest income | 1,191 | 986 | 841 |
| **Total income** | 2,129 | 1,835 | 1,590 |
| Direct expenses | | | |
|  staff costs | 259 | 211 | 190 |

| | | | |
|---|---|---|---|
|  other | 453 | 446 | 411 |
| | 712 | 657 | 601 |
| Contribution before provisions | 1,417 | 1,178 | 989 |
| Provisions | 377 | 297 | 281 |
| **Contribution** | 1,040 | 881 | 708 |

| | £bn | £bn | £bn |
|---|---|---|---|
| Total assets | 26.9 | 21.9 | 19.4 |
| Loans and advances to customers  gross | | | |
|  mortgages | 9.2 | 8.2 | 7.0 |
|  other | 16.0 | 13.8 | 12.4 |
| Customer deposits | 4.4 | 4.4 | 4.4 |
| Weighted risk assets | 21.1 | 16.8 | 14.4 |

* prior periods have been restated to reflect the transfer in 2004 of certain activities to Manufacturing.

*2004 compared with 2003*

Contribution increased by 18% or £159 million to £1,040 million.

Total income was up 16% or £294 million to £2,129 million, reflecting continued strong growth across all products, particularly credit cards. Excluding acquisitions income rose by 9%, £155 million, and contribution was up by 14%, £125 million. Net interest income was up 10% or £89 million to £938 million. Average lending rose by 19% to £24.2 billion, of which average mortgage lending was 16% higher at £8.8 billion, mainly in The One account. Average customer deposits were stable. The new MINT branded credit card was launched in December 2003 and while the 0% introductory interest rate for nine months on MINT cards depressed net interest margin, over 711,000 MINT credit cards have been issued and attracted significant balances. During 2004, the total number of customer accounts increased by 2.3 million.

Non-interest income was up 21% or £205 million to £1,191 million, reflecting increased volumes and acquisitions.

Direct expenses increased by 8% or £55 million to £712 million. Staff costs were up 23%, due to the acquisitions and increased headcount to support higher business volumes. Excluding acquisitions, staff costs were up 8%. The increase in other expenses was limited to 2%, as a result of tight cost management and efficiencies within the core businesses.

The charge for provisions for bad debts increased by £80 million or 27% to £377 million, reflecting the growth in lending volumes and the acquisition of the credit card business from People's Bank.

Excluding acquisitions, provisions for bad debts were up 14%, £41 million. Credit metrics across the portfolio remain broadly stable, however consistent with the market there was some increase in the levels of arrears towards the end of the year in credit cards.

*2003 compared with 2002*

Contribution increased by 24% or £173 million to £881 million.

Total income was up 15% or £245 million to £1,835 million, reflecting continued strong growth in supermarket banking (TPF), mortgages and cards. Net interest income was up 13% or £100 million to £849 million. Average lending rose by 15% to £20.3 billion of which average mortgage lending was 20% higher at £7.6 billion mainly in The One account. Average customer deposits were up 5% to £4.4 billion. During 2003, the total number of customer accounts increased by 1.7 million.

Non-interest income was up 17% or £145 million to £986 million. There was good growth in insurance and ATM income resulting from increased volumes, particularly in TPF and in the Cards Business.

Direct expenses increased by 9% or 7% excluding acquisitions, and other expenses increased by £35 million, 9% (7% excluding acquisitions), with increased processing and operational costs in support of the higher business levels.

The charge for provisions for bad debts increased by £16 million or 6% to £297 million, reflecting growth in lending volumes offset by higher recoveries. The indicators of credit quality remained stable.

30

**Manufacturing**

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Staff costs | 794 | 671 | 571 |
| Other costs | 1,645 | 1,443 | 1,381 |
| **Total manufacturing costs** | 2,439 | 2,114 | 1,952 |
| Analysis: | | | |
| Group Technology | 807 | 686 | 665 |
| Group Purchasing and Property Operations | 854 | 718 | 649 |
| Customer Support and other operations | 778 | 710 | 638 |
| Total manufacturing costs | 2,439 | 2,114 | 1,952 |

* prior periods have been restated to reflect the transfer in 2004 of certain activities, principally from RBS Insurance and Ulster Bank.

*2004 compared with 2003*

Manufacturing's costs increased by £325 million, 15% to £2,439 million.

Manufacturing is now supporting RBS Insurance and Ulster Bank and of the £325 million increase, £82 million reflects technology and property operations of Churchill (2004 – £96 million; 2003 – £33 million) and First Active (2004 – £19 million; 2003 – £nil) which were acquired in September 2003 and January 2004 respectively.

The balance of the increase was required to support higher business volumes, to upgrade the Group's regional property portfolio and to invest in the Group Efficiency Programme initiatives that are improving the Group's overall efficiency.

A number of initiatives aimed at improving efficiency and customer service were introduced in the year, including a sales prompt system on screens in NatWest branches and in RBS and NatWest telephony: enhanced fraud prevention; conversion of paper based branch reports to screen; image and workflow capability in service centres; the introduction of a new image enabled mortgage platform which has improved the efficiency and quality of our service and the introduction of an on-line customer query management system.

*2003 compared with 2002*

Manufacturing□s costs increased by 8% or £162 million, to £2,114 million.

Group Technology costs increased by £21 million to £686 million. This reflected business as usual cost growth and a specific improvement programme, the majority of the cost of which will be borne by Group Technology. This is providing benefits across the Group and further investment opportunities were identified which will lead to further efficiency benefits across the Group.

The cost base of Group Purchasing and Property Operations rose by 11% or £69 million to £718 million, largely as a result of the continuing upgrade of the property portfolio in major UK centres to support the Group□s core business.

Customer Support and other operations costs were £710 million, 11% or £72 million higher than the previous year. This reflected further expansion of business operations with increased expenditure in customer support areas of Lending, Telephony, Payments and Security. In telephony, the Royal Bank of Scotland customer service proposition was introduced to NatWest customers who can now choose between speaking to their local branch, to a customer service officer or using the automated telephone service.



## **Operating and financial review** continued

**Wealth Management**

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Net interest income | 497 | 457 | 451 |
| Non-interest income | 451 | 352 | 370 |
| **Total income** | 948 | 809 | 821 |
| Expenses | | | |
| □ staff costs | 299 | 259 | 279 |
| □ other | 164 | 139 | 146 |
| | 463 | 398 | 425 |
| Contribution before provisions | 485 | 411 | 396 |
| Provisions for bad and doubtful debts □ charge/(release) | 17 | 9 | (11) |
| **Contribution** | 468 | 402 | 407 |

| | £bn | £bn | £bn |
|---|---|---|---|
| Loans to customers | 9.2 | 7.9 | 7.3 |
| Investment management assets □ excluding deposits | 22.3 | 22.3 | 16.1 |
| Customer deposits | 31.7 | 29.1 | 28.9 |
| Weighted risk assets | 8.3 | 9.1 | 8.4 |

* prior periods have been restated to reflect the transfer of certain activities to Retail Banking and Manufacturing.

*2004 compared with 2003*

Contribution at £468 million was £66 million or 16% higher than 2003. Excluding the acquisition and adjusting for the disposal, contribution was up 14%, £54 million.

Total income increased by 17% or £139 million to £948 million, including a full year contribution from Bank von Ernst. Excluding the acquisition and disposal, income was 12%, £94 million higher.

Net interest income increased by 9% or £40 million to £497 million. The increase reflects growth in both lending and deposit volumes, combined with the benefit of higher average interest rates.

Non-interest income increased by 28% or £99 million to £451 million, reflecting higher fee income as a result of the improved equity markets and the acquisition of Bank von Ernst.

Investment management assets were stable at £22.3 billion. Excluding the acquisition and disposal and at constant exchange rates, investment assets increased 7%.

Expenses were up by 16% or £65 million to £463 million to support the growth in income and reflecting the acquisition of Bank von Ernst. Excluding the acquisition and disposal, expenses were up 9%, £33 million.

The charge for provisions for bad and doubtful debts was £17 million compared with £9 million in 2003, reflecting a small number of specific cases.

*2003 compared with 2002*

Contribution was £402 million, £5 million or 1% lower than 2002. Excluding the acquisition and disposals, income was up 1%, with contribution before provisions up 4%. The charge for provisions for bad and doubtful debts was £9 million compared with a net release of £11 million in 2002.

Total income was down by 1% or £12 million to £809 million.

Net interest income increased by 1% or £6 million to £457 million. The benefit from growth in lending volumes was partly negated by the effect of lower interest rates which also caused a tightening of deposit margins.

Non-interest income declined by 5% or £18 million to £352 million. Excluding the acquisition and disposals the decrease was 1%. This reflected the impact of lower equity markets adversely affecting fees and commissions.

Investment management assets increased by £6.2 billion or 39% to £22.3 billion principally due to the acquisition of Bank von Ernst in the year.

Expenses were down by 6% or £27 million to £398 million reflecting tight cost control in difficult market conditions and the 7% reduction in staff numbers since 31 December 2002.

Provisions for bad and doubtful debts were £9 million compared with a net release of £11 million in 2002.



**RBS Insurance**

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Earned premiums | 5,357 | 3,627 | 2,442 |
| Reinsurers share | (413) | (504) | (489) |
| Insurance premium income | 4,944 | 3,123 | 1,953 |
| Net fees and commissions | (488) | (161) | 6 |
| Other income | 478 | 283 | 180 |
| **Total income** | 4,934 | 3,245 | 2,139 |
| Expenses | | | |
| staff costs | 293 | 222 | 166 |
| other | 299 | 219 | 167 |
| | 592 | 441 | 333 |
| Gross claims | 3,724 | 2,644 | 1,693 |
| Reinsurers share | (244) | (449) | (343) |
| Net claims | 3,480 | 2,195 | 1,350 |
| **Contribution** | 862 | 609 | 456 |

| | | | |
|---|---|---|---|
| In-force policies (000s) | | | |
| Motor: UK | 8,338 | 8,086 | 4,668 |
| Motor: Continental Europe | 1,639 | 1,425 | 1,165 |
| Other (including home, rescue, pet): UK | 10,919 | 10,518 | 6,697 |
| Gross insurance reserves total (£m) | 7,394 | 6,582 | 3,002 |

* prior periods have been restated to reflect the transfer in 2004 of certain activities to Manufacturing and to recognise a reclassification of income from net fees and commissions to insurance premium income.

*2004 compared with 2003*

Contribution increased by 42% or £253 million to £862 million and included the first full year's contribution from Churchill, which was acquired in September 2003. Excluding Churchill, contribution grew by 13%, £73 million.

Total income was up 52% or £1,689 million to £4,934 million. Excluding Churchill, total income grew by 17%, £450 million.

After reinsurance, insurance premium income was up 58% or £1,821 million to £4,944 million. Excluding Churchill, net insurance premium income grew by 17%. At 31 December 2004, the number of UK in-force motor insurance policies was 8.3 million and the number of in-force motor policies in Continental Europe was 1.6 million. The International Division passed the milestone of 1 million motor policies in Spain in December. Non-motor policies, including home, rescue and pet insurance, increased to 10.9 million at 31 December 2004.

Net fees and commissions payable increased from £161 million to £488 million, due mainly to commissions payable to intermediaries in the broker division acquired as part of Churchill. Other income was up due to the acquisition of Churchill and increased investment income driven by higher business volumes.

Expenses increased by 34% or £151 million to £592 million. Excluding Churchill, expenses increased by 10%, £37 million, to support higher business volumes.

Net claims, after reinsurance, increased by 59% or £1,285 million to £3,480 million. Excluding Churchill, net claims increased by 20%, consistent with mix and volume growth.

The UK combined operating ratio, which includes manufacturing costs, was 93.7% compared with 91.2% for 2003. This deterioration is attributable in part to a change in business mix due to the full year impact of commissions payable to brokers and intermediaries in Churchill. Excluding Churchill, the UK ratio was broadly in line with the prior year (2004  89.9%; 2003  88.6%).

*2003 compared with 2002*

Contribution increased by 34% or £153 million to £609 million. Excluding Churchill, contribution increased by 22% or £99 million.

Total income was up 52% or £1,106 million to £3,245 million. Excluding Churchill, total income grew by 25% or £525 million.

After reinsurance, insurance premium income was up 60% or £1,170 million to £3,123 million. Excluding Churchill, insurance premium income (net of reinsurance) grew by 25% or £490 million. The number of UK in-force motor insurance policies increased by 3.4 million of which 3.1 million was from Churchill, while the number of UK in-force home insurance policies increased by 3.6 million including 3.4 million from Churchill. The number of motor policies in Continental Europe increased by 260,000 during the year.

Other income net of commissions payable was down from £186 million to £122 million. Excluding Churchill, which included £148 million commissions payable to brokers and intermediaries, other income was up 19% or £35 million due to higher investment income, embedded value profits and share of associates profits.

Expenses increased by 32% or £108 million to £441 million. Excluding Churchill, expenses increased by 10% or £33 million. Staff numbers, excluding Churchill, increased by 4% (400) to support growth in business volumes, particularly in the partnership business.

Net claims, after reinsurance, increased by 63% or £845 million to £2,195 million. Excluding Churchill, net claims increased by 29% or £393 million.

UK combined operating ratio was 91.2%. Excluding Churchill, the UK ratio was 88.6% compared with 88.2% for 2002.

33

## **Operating and financial review** continued

**Ulster Bank**

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Net interest income | 550 | 396 | 339 |
| Non-interest income | 193 | 185 | 181 |

| | | | |
|---|---|---|---|
| **Total income** | 743 | 581 | 520 |
| Expenses | | | |
| – staff costs | 158 | 137 | 122 |
| – other | 77 | 58 | 58 |
| | 235 | 195 | 180 |
| Contribution before provisions | 508 | 386 | 340 |
| Provisions | 40 | 32 | 22 |
| **Contribution** | 468 | 354 | 318 |

| | £bn | £bn | £bn |
|---|---|---|---|
| Total assets | 27.4 | 15.6 | 12.7 |
| Loans and advances to customers – gross | | | |
| – mortgages | 8.8 | 2.8 | 1.8 |
| – other | 12.9 | 8.8 | 7.3 |
| Customer deposits | 13.5 | 9.7 | 8.8 |
| Weighted risk assets | 18.5 | 11.0 | 9.0 |
| Average exchange rate – €/£ | 1.474 | 1.445 | 1.591 |
| Spot exchange rate – €/£ | 1.418 | 1.416 | 1.536 |

* prior periods have been restated to reflect the transfer in 2004 of certain activities to Manufacturing.

*2004 compared with 2003*

Contribution increased by 32% or £114 million to £468 million.

Total income increased by 28% or £162 million to £743 million reflecting the acquisition of First Active and strong organic growth, particularly in residential mortgages. Adjusting for First Active and the disposal in October 2003 of NCB Stockbrokers ('NCB'), income increased by 12% at constant exchange rates. During 2004, the number of customers increased by 454,000, of which 374,000 relate to First Active.

Net interest income rose by 39% or £154 million to £550 million, reflecting strong growth across all customer lending products and in customer deposits. Excluding First Active and NCB and at constant exchange rates, net interest income increased by 14%. The net interest margin decreased mainly due to strong growth in low risk mortgage lending both organic and due to the acquisition of First Active, a leading mortgage provider in the Republic of Ireland. Underlying product margins remain stable.

Non-interest income increased by £8 million, 4% to £193 million. Strong growth in lending fees and sales of treasury products was partially offset by a reduction in brokerage fees following the disposal of NCB. Excluding First Active and NCB, non-interest income was up 6%, £10 million.

Expenses increased by 21% or £40 million to £235 million. Excluding First Active and NCB expenses increased by 8% to support the growth in business.

The charge for provisions for bad debts increased by £8 million to £40 million, reflecting the growth in lending business. Excluding First Active and NCB provisions for bad and doubtful debts were up £4 million. Asset quality remains strong.

*2003 compared with 2002*

Contribution increased by 11% or £36 million to £354 million driven by strong volume growth in both loan and deposit products. The number of customers increased in 2003 by 36,000.

Total income increased by 12% or £61 million to £581 million reflecting the strong volume growth, in particular residential mortgages.

Net interest income rose by 17% or £57 million to £396 million, reflecting strong growth in both average customer lending and deposits which increased by 26% or £2.1 billion, to £10.1 billion and by 13% or £1.0 billion, to £8.9 billion respectively.

Non-interest income increased by £4 million to £185 million. Strong growth in lending, transmission and card fee income was partially offset by lower dealing profits. Uncertainty in equity markets adversely affected brokerage fees in the stockbroking business which was sold in October 2003.

Expenses increased by 8% or £15 million to £195 million. This reflected the annual pay award and the additional costs to support increased business volumes.

The charge for provisions for bad debts was up £10 million to £32 million reflecting growth in lending.



**Citizens**

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Net interest income | 1,540 | 1,310 | 1,248 |
| Non-interest income | 601 | 514 | 468 |
| **Total income** | 2,141 | 1,824 | 1,716 |
| Expenses | | | |
|  staff costs | 551 | 505 | 485 |
|  other | 473 | 374 | 370 |
| | 1,024 | 879 | 855 |
| Contribution before provisions | 1,117 | 945 | 861 |
| Provisions | 80 | 88 | 95 |
| **Contribution** | 1,037 | 857 | 766 |

| | $bn | $bn | $bn |
|---|---|---|---|
| Total assets | 132.1 | 76.8 | 61.1 |
| Loans and advances to customers  gross | 83.4 | 43.5 | 31.4 |

| | | | |
|---|---|---|---|
| Customer deposits | 99.2 | 62.8 | 51.1 |
| Weighted risk assets | 87.4 | 50.8 | 38.8 |
| | | | |
| Average exchange rate  $/£ | 1.832 | 1.635 | 1.503 |
| Spot exchange rate  $/£ | 1.935 | 1.786 | 1.613 |

*2004 compared with 2003*

Contribution was affected by the weak US dollar relative to sterling and at £1,037 million was up 21%, £180 million. In US dollar terms, contribution increased by 36% or $499 million to $1,900 million. Excluding the acquisitions, contribution increased by 13% or $183 million to $1,570 million.

Total income was up 31% or $939 million to $3,923 million. During 2004, Citizens increased its personal customer base by 1,993,000 accounts and its business customers by 174,000. Excluding the acquisitions, Citizens increased its personal customers by 199,000 and its business customers by 30,000.

Net interest income increased by 32% or $678 million to $2,821 million, reflecting the acquisitions and strong organic growth in both personal loans and deposits. Excluding the acquisitions, net interest income increased by 11% or $228 million, average loans were up 24% or $8.8 billion and average deposits were up 14% or $8.0 billion. The benefit from higher volumes more than offset the impact of interest rates on margins.

Non-interest income rose by 31% or $261 million to $1,102 million. Excluding the acquisitions, non-interest income increased 6% or $47 million before a reduction in mortgage fees, down from $53 million to $24 million in 2004.

Expenses increased by 31% or $439 million to $1,877 million. Excluding acquisitions, expenses were up 7% due to additional costs to support higher business volumes, investment in branch automation and the expansion of traditional and supermarket banking in Mid Atlantic and New England.

Provisions increased by only $1 million to $146 million, with credit quality metrics remaining strong.

*2003 compared with 2002*

Contribution which increased by 12% or £91 million to £857 million was diminished by the weakening of the US dollar in relation to sterling. In US dollar terms, contribution increased by 22% or $250 million to $1,401 million.

Total income was up 16% or $406 million to $2,984 million.

Net interest income increased by 14% or $268 million to $2,143 million. Excluding the acquisitions, net interest income was up 9% or $164 million (£100 million), reflecting strong organic growth in personal loans and deposits. Excluding the acquisitions, average loans were up 29% or $8.0 billion and average deposits were up 20% or $9.1 billion. The benefit of this growth was reduced by a narrowing interest margin due to reductions in US interest rates.

Non-interest income rose by 20% or $138 million to $841 million. Excluding the acquisitions, non-interest income was up 16% or $115 million (£70 million).

Expenses increased by 12% or $153 million to $1,438 million. Excluding the acquisitions, expenses increased by 8% or $102 million (£62 million), to support higher business volumes and expansion of Citizens supermarket banking programme.

Provisions were up $3 million from $142 million to $145 million. Excluding the acquisitions, provisions were $2 million (£1 million), or 1%, lower than 2002. Credit quality metrics remained strong and total non-performing loans were 0.40% of total loans and advances at 31 December 2003 compared with 0.57% at the end of 2002.

In 2003, Citizens increased its personal customer base by 376,000 accounts and its business customers by 36,000 due to growth through both traditional and supermarket branches, and the acquisition of Commonwealth Bancorp, Inc., Port Financial Corp. and Community Bancorp, Inc.



## **Operating and financial review** continued

### Central items

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Funding costs | 284 | 215 | 215 |
| Departmental and corporate costs | 595 | 496 | 283 |
| **Total Central items** | 879 | 711 | 498 |

* prior periods have been restated following the implementation of FRS 17.

*2004 compared with 2003*

Total Central items increased by £168 million to £879 million.

Funding costs at £284 million, were up 32% or £69 million reflecting the funding of the various acquisitions undertaken by the Group during the year.

Changes in net pension costs on the adoption of FRS 17 are reported in Central items. These comprise higher pension cost of £81 million partially offset by the expected return on pension scheme assets less interest on scheme liabilities of £33 million.

Central departmental costs and other corporate items at £595 million were £99 million or 20% higher than 2003. This is principally due to higher Group pension costs, up £48 million, the centralisation of certain functions and expenditure on Group-wide projects such as International Accounting Standards and Basel II.

*2003 compared with 2002*

Total Central items increased by £213 million to £711 million.

Funding costs were £215 million. Increased income from higher shareholders funds was offset by the funding costs associated with the acquisition of Churchill in September 2003 and the £1.5 billion AVS dividend paid in December 2003.

Central departmental costs and other corporate items at £496 million were £213 million or 75% higher than 2002. Net pension costs increased by £172 million reflecting lower returns on pension scheme assets together with increased pension costs. This was also partly due to staff costs and other costs relating to certain departments such as Customer Relations which have been centralised and additional resources devoted to Group wide projects such as preparations for the implementation of Basel II and International Accounting Standards.

**Employee numbers at 31 December**

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| Corporate Banking and Financial Markets | 16,400 | 15,900 | 16,900 |
| Retail Banking* | 32,200 | 31,100 | 30,500 |
| Retail Direct | 9,700 | 7,300 | 7,000 |
| Manufacturing* | 24,900 | 23,400 | 23,200 |
| Wealth Management* | 5,200 | 5,200 | 5,600 |
| RBS Insurance* | 19,500 | 18,800 | 10,300 |
| Ulster Bank* | 4,100 | 3,400 | 3,300 |
| Citizens | 22,600 | 14,100 | 13,300 |
| Centre | 2,000 | 1,700 | 1,700 |
| **Group total** | 136,600 | 120,900 | 111,800 |
| Acquisitions in the year | 10,500 | 9,700 | 5,600 |
| Underlying | 126,100 | 111,200 | 106,200 |

*prior periods have been restated to reflect the transfer in 2004 of certain activities from Wealth Management to Retail Banking and from F

*2004 compared with 2003*

The number of employees increased by 15,700, 13% to 136,600. The acquisitions in the year added 10,500 staff, including over 8,100 relating to Charter One.

*2003 compared with 2002*

The number of employees increased by 9,100, 8% to 120,900. The acquisition of Churchill added 8,500 staff in RBS Insurance.



## **Operating and financial review** continued

**Consolidated balance sheet**
**at 31 December 2004**

| | 2004 £m | 2003* £m |
|---|---|---|
| **Assets** | | |
| Cash and balances at central banks | 4,293 | 3,822 |
| Items in the course of collection from other banks | 2,629 | 2,501 |
| Treasury bills and other eligible bills | 6,110 | 4,846 |
| Loans and advances to banks | 58,260 | 51,891 |
| Loans and advances to customers | 345,469 | 252,531 |
| Debt securities | 91,211 | 79,949 |
| Equity shares | 2,960 | 2,300 |

| | | |
|---|---|---|
| Intangible fixed assets | 17,576 | 13,131 |
| Tangible fixed assets | 16,294 | 13,927 |
| Settlement balances | 5,682 | 2,857 |
| Other assets | 22,255 | 17,807 |
| Prepayments and accrued income | 6,928 | 5,309 |
| | 579,667 | 450,871 |
| Long-term assurance assets attributable to policyholders | 3,800 | 3,557 |
| **Total assets** | 583,467 | 454,428 |
| **Liabilities** | | |
| Deposits by banks | 99,081 | 67,323 |
| Items in the course of transmission to other banks | 802 | 958 |
| Customer accounts | 285,062 | 236,963 |
| Debt securities in issue | 58,960 | 41,016 |
| Settlement balances and short positions | 32,990 | 21,369 |
| Other liabilities | 26,152 | 20,584 |
| Accruals and deferred income | 15,588 | 13,155 |
| Post-retirement benefit liabilities | 1,901 | 1,445 |
| Provisions for liabilities and charges | 3,071 | 2,249 |
| Subordinated liabilities | 20,366 | 16,998 |
| Minority interests | | |
| equity | 158 | (11) |
| non-equity | 3,671 | 2,724 |
| Shareholders funds | | |
| equity | 27,345 | 23,175 |
| non-equity | 4,520 | 2,923 |
| | 579,667 | 450,871 |
| Long-term assurance liabilities attributable to policyholders | 3,800 | 3,557 |
| **Total liabilities** | 583,467 | 454,428 |
| **Analysis of repurchase agreements included above** | | |
| Reverse repurchase agreements and stock borrowing | | |
| Loans and advances to banks | 29,975 | 26,522 |
| Loans and advances to customers | 52,184 | 24,069 |
| | 82,159 | 50,591 |
| Repurchase agreements and stock lending | | |
| Deposits by banks | 43,342 | 27,044 |
| Customer accounts | 42,134 | 27,021 |
| | 85,476 | 54,065 |

* restated (see page 85)



**Overview of consolidated balance sheet**

Total assets of £583.5 billion at 31 December 2004 were up £129.0 billion, 28%, compared with 31 December 2003, reflecting business growth and acquisitions.

Treasury bills and other eligible bills increased by £1.3 billion, 26%, to £6.1 billion, reflecting trading activity.

Loans and advances to banks rose £6.4 billion, 12%, to £58.3 billion. Bank placings were up £2.9 billion, 11% to £28.3 billion, and reverse repurchase agreements and stock borrowing (reverse repos), were up £3.5 billion, 13%, to £30.0 billion.

Loans and advances to customers were up £92.9 billion, 37%, to £345.5 billion. Within this, reverse repos increased by £28.1 billion to £52.2 billion reflecting growth in trading activities. Excluding reverse repos, lending increased by £64.8 billion, 28% to £293.3 billion reflecting organic growth across all divisions and £23.4 billion arising from acquisitions, principally Charter One, £18.0 billion, First Active, £4.1 billion, and the People's Bank credit card business, £1.0 billion. In $ terms, Citizens grew US$39.5 billion, 92%, including US$32.7 billion related to acquisitions.

Debt securities increased by £11.3 billion, 14%, to £91.2 billion, principally due to increased holdings in Financial Markets and the acquisition of First Active.

Equity shares were up £0.7 billion, 29%, to £3.0 billion, mainly due to the acquisition of Charter One and growth in Financial Markets trading activity.

Intangible fixed assets increased by £4.4 billion, 34% to £17.6 billion. Goodwill arising on the acquisitions made during 2004 amounted to £5.9 billion, including £4.7 billion in respect of Charter One. This was partially offset by goodwill amortisation, £0.9 billion and the adverse effect of exchange rate movements, £0.5 billion.

Tangible fixed assets were up £2.4 billion, 17% to £16.3 billion, mainly reflecting growth in operating lease assets, up £1.4 billion, 22% to £7.8 billion.

Settlement balances increased by £2.8 billion to £5.7 billion as a result of increased levels of customer activity.

Other assets rose by £4.4 billion, 25% to £22.3 billion, mainly due to an increase in the mark-to-market value of trading derivatives and acquisitions.

Deposits by banks increased by £31.8 billion, 47% to £99.1 billion to fund business growth, with repurchase agreements and stock lending (repos) up £16.3 billion, 60%, to £43.3 billion and inter-bank deposits up £15.5 billion, 38% to £55.8 billion.

Customer accounts were up £48.1 billion, 20% at £285.1 billion. Within this, repos were up £15.1 billion, 56% to £42.1 billion reflecting growth in trading activities. Excluding repos, deposits rose by £33.0 billion, 16%, to £243.0 billion with growth in CBFM, £6.3 billion, Retail Banking, £4.1 billion, Wealth Management, £2.7 billion, Citizens, £15.8 billion, including the acquisition of Charter One and Ulster Bank, £3.8 billion, including First Active. In $ terms, Citizens grew US$36.4 billion, 58%, including US$29.1 billion related to acquisitions.

Debt securities in issue increased by £17.9 billion, 44%, to £59.0 billion primarily to meet the Group's funding requirements.

The increase in settlement balances and short positions reflected growth in customer activity.

Other liabilities rose by £5.6 billion, 27% to £26.2 billion, principally due to an increase in the mark-to-market value of trading derivatives.

Accruals and deferred income increased by £2.4 billion, 18% to £15.6 billion.

Post-retirement benefit liabilities, recognised on the adoption of FRS 17, were up £0.5 billion, 32% to £1.9 billion with actuarial losses, net of deferred tax, up £1.1 billion, mainly due to changes in actuarial assumptions, partially offset by asset growth and a £750 million payment to the RBS Group Pension Fund.

Provisions for liabilities and charges increased £0.8 billion, 37% to £3.1 billion principally due to higher provisions for deferred tax.

Subordinated liabilities were up £3.4 billion, 20% to £20.4 billion. This reflected the issue of £1.3 billion (US$2,425 million), £0.7 billion (€1,000 million) and £0.4 billion (AUD1,000 million) dated loan capital, and £1.1 billion (£1,100 million), £1.0 billion (€1,500 million) and £0.1 billion (JPY25 billion) undated loan capital, together with £0.1 billion of dated and undated loan capital arising from the acquisition of First Active and £0.2 billion dated loan capital arising from the acquisition of Charter One. This was partially offset by the redemption of dated loan capital, £0.7 billion (US$1,050 million and £140 million), the conversion of £0.5 billion (US$850 million) undated loan capital into US$ preference shares and the effect of exchange rate movements, £0.4 billion.

Non-equity minority interests were up £0.9 billion, 35% to £3.7 billion mainly reflecting the issues by subsidiaries of the Group of US$950 million (£0.5 billion) non-cumulative trust preferred securities in August 2004 and US$1,000 million (£0.6 billion) non-cumulative trust preferred securities in August/September 2004.

Shareholders' funds increased by £5.8 billion, 22% to £31.9 billion including £2.6 billion from the placing of 165 million ordinary shares in connection with the acquisition of Charter One, the issue of £1.3 billion preference share capital and conversion of £0.5 billion (US$850 million) undated loan capital into US$ preference shares. The remainder reflects retentions of £2.4 billion and the issue of £0.6 billion of ordinary shares in respect of scrip dividends and the exercise of share options and revaluation of premises, £0.1 billion, which were partly offset by £1.1 billion actuarial losses, net of deferred tax, recognised in post-retirement benefit schemes and the adverse effect of exchange rate movements on share premium account, £0.2 billion and profit and loss account, £0.4 billion.



## **Operating and financial review** continued

### Cash flow

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Net cash inflow from operating activities | 6,307 | 19,708 | 13,737 |
| Dividends received from associated undertakings | 9 | 9 | 1 |
| Returns on investments and servicing of finance | (1,070) | (956) | (1,103) |
| Taxation | (1,394) | (1,454) | (1,107) |
| Capital expenditure and financial investment | (1,526) | (6,965) | (9,185) |
| Acquisitions and disposals | (7,674) | (1,571) | (281) |
| Equity and AVS dividends paid | (1,235) | (2,235) | (1,527) |
| Financing | 9,369 | 4,128 | 2,711 |
| Increase in cash | 2,786 | 10,664 | 3,246 |

*2004*

The major factors contributing to the net cash inflow of £6,307 million from operating activities in 2004 were the profit before tax of £6,917 million, increases in deposits and debt securities in issue of £70,580 million, increases in short positions and settlement balances of £8,796 million, partially offset by increases in treasury and other eligible bills of £1,264 million, increases in securities of £10,367 million and increases in loans and advances of £72,913 million.

Interest on subordinated liabilities of £613 million and dividends of £457 million to preference and minority shareholders were paid during the year.

Net sales of investment securities of £1,232 million and net purchases of fixed assets of £2,758 million, including operating lease assets and investment properties, comprised the net cash inflow from capital expenditure and financial investment.

The issue of £1,075 million trust preferred securities and £4,624 million subordinated debt, partially offset by the repayment of £718 million of subordinated debt were the main contributors to the net cash inflow from financing of £9,369 million.

*2003*

The major factors contributing to the net cash inflow of £19,708 million from operating activities in 2003 were the profit before tax of £6,076 million, increases in deposits and debt securities in issue of £33,935 million, increases in short positions and settlement balances of £3,202 million and decreases in treasury and other eligible bills of £6,626 million, partially offset by the net increase in loans and advances of £23,343 million and increases in securities of £9,871 million.

Interest on subordinated liabilities of £557 million and dividends of £399 million to preference and minority shareholders were paid during the year.

Net purchases of investment securities of £3,056 million and fixed assets of £3,909 million, including operating lease assets and investment properties, comprised the net cash outflow from capital expenditure and financial investment.

Equity and Additional Value Shares (AVS) dividends paid includes the final dividend on the AVS of £1,463 million.

The issue of £883 million trust preferred securities and £3,817 million subordinated debt, partially offset by the redemption of preference shares of £364 million and repayment of £336 million of subordinated debt were the main contributors to the net cash inflow from financing of £4,128 million.

*2002*

The major factors contributing to the net cash inflow of £13,737 million from operating activities in 2002 were the profit before tax of £4,852 million and an increase in deposits, debt securities in issue and other liabilities of £40,981 million, which were partially offset by the increase in loans and advances of £35,426 million.

Interest on subordinated liabilities of £674 million and dividends of £429 million to preference and minority shareholders were paid during the year.

Net purchases of investment securities of £6,629 million and fixed assets of £2,556 million, including operating lease assets, comprised the net cash outflow from capital expenditure and financial investment.

Equity and AVS dividends paid includes the second dividend on the AVS of £798 million.

The issue of £1,242 million trust preferred securities and £2,157 million subordinated debt, partially offset by the redemption of preference shares of £600 million and repayment of £202 million of subordinated debt were the main contributors to the net cash inflow from financing of £2,711 million.



**UK GAAP compared with US GAAP**

The Group’s financial statements are prepared in accordance with UK GAAP, which differs in certain material respects from US GAAP as described on pages 133 to 145.

The net income available for ordinary shareholders under US GAAP was £3,948 million, £308 million lower than profit attributable to ordinary shareholders under UK GAAP of £4,256 million. The principle reasons for the decrease are:

- A reduction of £437 million relating to derivatives and hedging. Under US GAAP, non-derivative financial instruments cannot be designated as hedges of the foreign exchange exposure of available-for-sale securities; such hedging is permitted under UK GAAP. Under US GAAP, the Group has not designated any of its non-trading derivatives as hedges and these are recorded at fair value. Furthermore, US GAAP requires certain embedded derivatives to be accounted for separately from the host instrument.

- Higher pension costs under US GAAP compared with UK GAAP principally reflecting deferral of actuarial gains and losses over the average remaining service lives of current employees under US GAAP. Actuarial gains and losses are recognised in full in the statement of total recognised gains and losses for the period under UK GAAP.

- A net decrease in net income of £261 million relating to capitalisation and amortisation of software development costs that meet certain criteria under US GAAP. Such costs are generally charged to the profit and loss account under UK GAAP.

The above decreases are partially offset by an increase of £780 million in net income under US GAAP relating to intangible assets. Goodwilll amortisation is charged to the profit and loss account under UK GAAP whereas under US GAAP only intangible assets with finite lives are amortised. Goodwill is not amortised but instead is reviewed annually for impairment.

US GAAP shareholders’ equity at £36,191 million is £4,326 million higher than shareholders’ equity under UK GAAP, principally due to the reinstatement of goodwill amortised under UK GAAP and the reversal of the final dividend.

**Capital resources**

The following table analyses the Group’s regulatory capital resources at the period end:

| | 2004 £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|---|---|---|---|---|---|
| **Capital base** | | | | | |
| Tier 1 capital | 22,694 | 19,399 | 17,155 | 15,052 | 12,071 |
| Tier 2 capital | 20,229 | 16,439 | 13,271 | 11,734 | 10,082 |
| Tier 3 capital | — | — | — | 172 | 167 |
| | 42,923 | 35,838 | 30,426 | 26,958 | 22,320 |
| Less: investments in insurance subsidiaries, associated | (5,165) | (4,618) | (3,146) | (2,698) | (2,228) |

| | | | | | |
|---|---|---|---|---|---|
| undertakings and other supervisory deductions | | | | | |
| Total capital | 37,758 | 31,220 | 27,280 | 24,260 | 20,092 |
| **Weighted risk assets** | | | | | |
| Banking book: | | | | | |
| On-balance sheet | 261,800 | 214,400 | 193,800 | 176,000 | 146,600 |
| Off-balance sheet | 44,900 | 36,400 | 28,700 | 22,000 | 16,200 |
| Trading book | 17,100 | 12,900 | 11,500 | 12,500 | 12,400 |
| | 323,800 | 263,700 | 234,000 | 210,500 | 175,200 |
| **Risk asset ratios** | % | % | % | % | % |
| Tier 1 | 7.0 | 7.4 | 7.3 | 7.1 | 6.9 |
| Total | 11.7 | 11.8 | 11.7 | 11.5 | 11.5 |

It is the Group's policy to maintain a strong capital base, to expand it as appropriate and to utilise it efficiently throughout its activities to optimise the return to shareholders while maintaining a prudent relationship between the capital base and the underlying risks of the business. In carrying out this policy, the Group has regard to the supervisory requirements of the Financial Services Authority ('FSA'). The FSA uses Risk Asset Ratio ('RAR') as a measure of capital adequacy in the UK banking sector, comparing a bank's capital resources with its weighted risk assets (the assets and off-balance sheet exposures are 'weighted' to reflect the inherent credit and other risks); by international agreement, the RAR should be not less than 8% with a tier 1 component of not less than 4%. At 31 December 2004, the Group's total RAR was 11.7% (2003 – 11.8%) and the tier 1 RAR was 7.0% (2003 – 7.4%).



## **Operating and financial review** continued

### Risk management

### Framework

A number of high-level committees support the Board in the effective measurement and management of risk. Board subcommittees have the following roles and responsibilities:

- *Group Audit Committee* – is a non-executive committee that supports the Board in carrying out its responsibilities for financial reporting including accounting policies, and in respect of internal control and risk assessment. The Group Audit Committee monitors the ongoing process of the identification, evaluation and management of all significant risks throughout the Group. The Committee is supported by Group Internal Audit which provides an independent assessment of the adequacy and effectiveness of the Group's internal controls.

- *Advances Committee* – is an executive committee that deals with all transactions that exceed the Group Credit Committee's delegated authority, which in turn approves facility limits in excess of the authorities delegated to divisional credit committees.

In addition to the responsibilities at Board level outlined above, operational authority and oversight is delegated to the Group Executive Management Committee (“GEMC”), which is responsible for implementing a risk management framework consistent with the Board's risk appetite. The GEMC, in turn, is supported by:

- *Group Risk Committee* (“GRC”), which recommends and approves limits, processes and policies in respect of the effective management of all material risks across the Group.

- *Group Asset and Liability Management Committee* (“GALCO”) which is responsible for reviewing the balance sheet, funding and capital implications of the Group's strategy and operations. In addition, GALCO monitors and reviews legal, regulatory and accounting developments affecting balance sheet risks and capital. It also reviews the effect of external, economic and environmental changes on the Group's balance sheet, risks, margins and capital.

- *Group Risk Management* (“GRM”) reports to the GEMC through the Group Finance Director and is responsible for risk policy, measurement and controls across the Group. An assessment of the adequacy and effectiveness of each divisional risk management team is undertaken by GRM on a continuous basis to ensure effective control of risks. Each divisional risk function has a direct reporting line to the Director of Group Risk Management, which reinforces these controls and ensures independence of risk management within each division.

- *Group Treasury* (“GT”) also reports to the GEMC through the Group Finance Director, and is responsible for the management of the Group’s balance sheet, capital raising, liquidity and hedging policies. GT assesses and monitors the effectiveness of the divisional asset and liability management teams.

GRM and GT also respond to various regulatory developments affecting risk, capital and liquidity management. This includes working with international and domestic trade associations, being active with various regulators, especially the FSA, and encouraging discussions with the main regulatory and political groups, such as the Basel Committee and the EU Commission.

The principal risks that the Group manages are as follows:

- Credit risk
- Liquidity risk
- Market risk
- Insurance risk
- Enterprise risk

These risks are discussed on pages 43 to 58.



---

**Credit risk**

Credit risk is the risk arising from the possibility that the Group will incur losses from the failure of customers to meet their obligations.

*The credit risk framework*

The management of credit risk is undertaken within an agreed and regulated Credit Risk Framework which is defined in the Group’s “Principles for Managing Credit Risk”. These set out minimum standards for managing credit risk, defining and maintaining the credit risk framework, approving credit risk taken by the Group, credit stewardship and reviewing the effectiveness of the credit culture. These standards are used to manage the Group’s portfolio of credit risk assets.

All credit risk exposures require approval by authorised individuals or credit committees, independent of business revenue generation. Existing credit risk exposures are monitored and reviewed periodically against approved risk limits. Review occurs at least annually with the lower quality exposures being subject to greater frequency of analysis and assessment. Exposures below specified thresholds and meeting specific criteria can be approved through authorised, largely automated, processes.

Different credit approval processes exist for each customer type in order to ensure appropriate skills and resources are employed in credit assessment and approval. Corporate risk exposures are aggregated to determine the appropriate level of credit approval required and to facilitate consolidated credit risk management:

- *Retail and personal* businesses employ market best practice credit scoring techniques to process small scale, large volume credit decisions. Scores from such systems are combined with management judgement to ensure an effective ongoing process of approval, review and enhancement. Credit decisions for loans above specified thresholds, including lending to SMEs, are individually assessed.
- *Assessments* of corporate borrower and transaction risk are undertaken using a range of credit rating models supplemented by the judgement of relationship managers. Specialist internal credit risk departments independently oversee the credit process and make decisions or recommendations to the appropriate credit committee. Credit authority is not extended to relationship managers.
- *Financial Markets* counterparties are approved by a dedicated credit function which specialises in the traded market product risk.

GRM and the GEMC review the reports on the Group’s portfolio of credit risks on a monthly basis.



---

## **Operating and financial review** continued

**Credit risk (continued)**

*Risk asset quality*

Internal reporting and oversight of risk assets is principally differentiated by credit ratings. Internal ratings are used to assess the credit quality of borrowers. Customers are assigned credit ratings, based on statistical and judgemental rating systems that map to a Group asset quality scale reflecting the probability of default. Over the past year, RBS has made significant strides in updating its credit grading models to take account of the new Basel Capital Accord (see page 165).

As at December 2004, exposure to investment grade counterparties (AQ1) accounted for over half of risk assets. Over 97% of exposures were to counterparties rated AQ4 or higher.

| Asset quality | S&P equivalent |
| --- | --- |

| | |
|---|---|
| AQ1 | AAA to BBB- |
| AQ2 | BB+ to BB |
| AQ3 | BB- to B+ |
| AQ4 | B+ to B |
| AQ5 | B and below |

*Loans and advances*

The Groups loan portfolio consists of loans (including overdraft facilities), instalment credit and finance lease receivables. The value of loans and advances to customers at 31 December 2004 was £349,691 million (2003  £256,453 million), representing an increase of £93,238 million (36%) over the year, of which £23,468 million relates to the largest three acquisitions (Charter One, First Active & Peoples Bank Cards) and £28,115 million relates to growth in reverse repo activity. Including banks, total loans and advances at 31 December 2004 was £407,957 million (2003  £308,351 million), an increase of 32%.

| Loans and advances  gross | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Loans and advances to customers by division  gross | | | |
| CBFM | 176,690 | 128,124 | 117,365 |
| Retail Banking | 72,197 | 61,809 | 55,619 |
| Retail Direct | 25,206 | 22,024 | 19,350 |
| Wealth Management | 9,221 | 7,894 | 7,267 |
| Ulster Bank | 21,659 | 11,633 | 9,111 |
| Citizens | 43,104 | 24,384 | 19,457 |
| Other | 1,614 | 585 | (925) |
| Loans and advances to customers  gross | 349,691 | 256,453 | 227,244 |
| Loans and advances to banks  gross | 58,266 | 51,898 | 44,303 |
| Total loans and advances  gross | 407,957 | 308,351 | 271,547 |



*Industry analysis*

Industry analysis plays an important part in assessing potential concentration risk within the loan portfolio. Particular attention is given to industry sectors where the Group believes there is a higher degree of risk or potential for volatility in the future.

| Loans and advances to customers by industry | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Central and local government | 3,079 | 2,100 | 2,385 |
| Finance | 70,453 | 38,936 | 34,079 |
| Individuals  home mortgages | 91,657 | 61,960 | 49,986 |
|  other | 43,875 | 35,027 | 30,021 |

| | | | |
|---|---|---|---|
| Other commercial and industrial comprising: | | | |
| Manufacturing | 14,883 | 12,769 | 14,715 |
| Construction | 7,976 | 5,839 | 5,152 |
| Service industries and business activities | 57,305 | 50,772 | 48,155 |
| Agriculture, forestry and fishing | 3,024 | 3,081 | 3,026 |
| Property | 41,113 | 31,629 | 26,593 |
| Finance leases and instalment credit | 16,326 | 14,340 | 13,132 |
| Total loans and advances to customers – gross | 349,691 | 256,453 | 227,244 |

The increase in Finance was principally due to higher level of reverse repurchase agreements which by industry were as follows:

| Reverse repurchase agreements | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Central and local government | 1,413 | 1,079 | 1,000 |
| Finance | 50,771 | 22,883 | 20,941 |
| Service industries and business activities | – | 107 | – |
| Total | 52,184 | 24,069 | 21,941 |

Together, corporates, financial institutions and sovereigns, account for 61% of loans and advances. The remaining exposures, accounting for 39% of loans and advances, relate to personal and retail customers, especially mortgage lending and other small loans that are intrinsically highly diversified.



## **Operating and financial review** continued

### Credit risk (continued)

*Geographic analysis*

Although the Group is active in 27 different countries, its principal focus is on the UK, US and Europe.

Geographically, 90% of loans and advances to customers fall within the UK or US, both of which have experienced stable or improving economic growth. Europe accounts for about 9% of loans and advances to customers.

| Loans and advances to customers by geography | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| UK | 240,642 | 194,545 | 168,931 |
| US | 74,045 | 40,373 | 41,008 |
| Europe | 32,113 | 19,842 | 15,572 |
| Rest of the World | 2,891 | 1,693 | 1,733 |
| Total loans and advances to customers – gross | 349,691 | 256,453 | 227,244 |

Notes:

(1) The geographic analysis is based on location of office. The UK includes domestic transactions and transactions conducted through the offices in the UK which service international banking transactions.

*Cross border exposures*

Cross border exposures are defined as loans to banks and customers (including finance lease and instalment credit receivables) and other monetary assets, including non-local currency claims of overseas offices on local residents.

The Group monitors the geographical breakdown of these exposures based on the country of domicile of the borrower or guarantor of ultimate risk.

The table below sets out the Groups cross border outstandings in excess of 0.75% of Group total assets (including acceptances), which totalled £583.8 billion (2003  £455.0 billion; 2002  £413.6 billion). None of these countries has experienced repayment difficulties that have required refinancing of outstanding debt.

| | 2004<br>£m | 2003<br>£m | 2002<br>£m |
|---|---|---|---|
| Geographic analysis: | | | |
| United States | 28,795 | 14,618 | 11,658 |
| Germany | 14,050 | 15,073 | 10,464 |
| France | 9,604 | 7,524 | 5,971 |
| Netherlands | 8,871 | 6,830 | 6,318 |
| Cayman Islands | 7,258 | 6,666 | 6,897 |
| Spain | 5,249 | 3,421 | * |
| Japan | 4,610 | 4,141 | 3,156 |

* Less than 0.75% of Group total assets (including acceptances).



*Risk elements in lending and potential problem loans*

The table below sets out the Groups loans that are classified as non-accrual, accruing past due and restructured loans (together risk elements in lending (REIL)) or potential problem loans (PPL) as defined by the SEC in the US. The figures incorporate estimates and are stated before deducting the value of security held or related provisions.

| REIL and PPL | 2004<br>£m | 2003<br>£m | 2002<br>£m |
|---|---|---|---|
| Non-accrual loans (2) | 4,780 | 4,432 | 4,175 |
| Accrual loans past due 90 days (3) | 725 | 642 | 492 |
| Troubled debt restructurings | 24 | 83 | 204 |
| Total REIL | 5,529 | 5,157 | 4,871 |
| PPL (4) | 280 | 591 | 1,183 |
| Total REIL and PPL | 5,809 | 5,748 | 6,054 |

Notes:

(1) The classification of a loan as non-accrual, past due 90 days or troubled debt restructuring does not necessarily indicate that the principal of the loan is uncollectable in whole or in part. Collection depends in each case on the individual circumstances of the loan, including the adequacy of any collateral securing the loan and therefore

classification of a loan as non-accrual, past due 90 days or troubled debt restructuring does not always require that a provision be made against such a loan. In accordance with the Group's provisioning policy for bad and doubtful debts, it is considered that adequate provisions for the above risk elements in lending have been made.

(2) The Group's UK banking subsidiary undertakings account for loans on a non-accrual basis from the point in time at which the collectability of interest is in significant doubt. Certain subsidiary undertakings of the Group, principally Citizens, generally account for loans on a non-accrual basis when interest or principal is past due 90 days.

(3) Overdrafts generally have no fixed repayment schedule and consequently are not included in this category.

(4) Loans which are current as to the payment of principal and interest but in respect of which management have serious doubts about the ability of the borrowers to comply with contractual repayment terms. Substantial security is held in respect of these loans and appropriate provisions are made in accordance with the Group's provisioning policy for bad and doubtful debts.

REIL increased to £5,529 million, a rise of 7% compared with 2003 partly due to acquisitions made in 2004. REIL as a proportion of total loans and advances to customers was 1.58% in 2004 (2003 – 2.01%; 2002 – 2.14%), reflecting active risk management, growth in lower risk portfolios and improvements in the economic environment in the Group's key markets.

REIL and PPL in aggregate, as a proportion of loans and advances also shows an improving trend, accounting for 1.66% of loans and advances to customers in 2004 (2003 – 2.24%; 2002 – 2.66%).

*Provisions*

The Group provides for losses in its loan portfolio so as to record impaired loans and advances at their expected ultimate net realisable value. The objective is to set provisions based on the current understanding of the portfolio. To reach this understanding, retail and corporate loans and advances are treated separately.

The Group's retail portfolios which consist of small value, high volume credits have highly efficient largely automated processes for identifying problem credits and very short timescales, typically three months, before resolution or adoption of various recovery measures.

Corporate portfolios consist of higher value, lower volume credits, which tend to be structured to meet individual customers requirements. These portfolios do not have an automated provisioning process, relying on individual expert judgement and provisioning committees to provide the necessary controls and oversight to identify problems.

Early and proactive management of problem exposures ensures that credit losses are minimised. Specialised units are used for different customer types to ensure that the appropriate risk mitigation is taken in a timely manner.



## **Operating and financial review** continued

**Credit risk (continued)**

*Specific and general provisions*

Provisions fall into one of two categories, specific or general:

- *Specific provisions:* arise when the creditworthiness of a borrower has undergone a significant deterioration and the recovery of the advance is in significant doubt. The amount of specific provision reflects the financial condition of the borrower, the realisable value of security and the costs of recovery.

- *General provisions:* cover losses that have not yet been specifically identified but are known from experience to be present in any portfolio of loans. The level of general provision reflects the size and diversity of the Groups loan portfolio, past experience, the current state of the economies in which the Group operates and the scope of specific provisioning procedures.

| Provision charge | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Charge to profit and loss account for bad and doubtful debts | 1,428 | 1,461 | 1,286 |
| Charge as a percentage of average loans and advances to customers | 0.48% | 0.59% | 0.61% |

Provisions for bad and doubtful debts charged to the profit and loss account in 2004 were £1,428 million, down £33 million (2%) from £1,461 million in 2003. Expressed as a percentage of average loans and advances to customers, the bad and doubtful debt charge improved to 0.48%, from 0.59% in 2003.

| Summary of provisions | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Specific provision1 | 3,648 | 3,356 | 3,323 |
| General provision | 574 | 566 | 597 |
| Total bad and doubtful debt provisions | 4,222 | 3,922 | 3,920 |
| Total loans and advances to customers | 349,691 | 256,453 | 227,244 |
| Specific provision as a percentage of loans and advances to customers | 1.04% | 1.31% | 1.46% |
| General provision as a percentage of loans and advances to customers | 0.17% | 0.22% | 0.26% |
| **Total provisions as a percentage of loans and advances to customers** | 1.21% | 1.53% | 1.72% |
| Closing provisions for bad and doubtful debts expressed as a: | | | |
| % of REIL | 76% | 76% | 80% |
| % of REIL and PPL | 73% | 68% | 65% |

(1) Excludes specific provisions against loans and advances to banks of £6 million (2003  £7 million; 2002  £7 million)

Total bad and doubtful debt provisions increased to £4,222 million in 2004, compared with £3,922 million in 2003, a rise of 8%, reflecting acquisitions, new provisions and write-offs net of recoveries and currency translations. The ratio of provisions to loans and advances to customers reduced from 1.53% at the end of 2003 to 1.21%.

The coverage ratio of closing provisions as a percentage of REIL remained stable at 76% while the coverage ratio of total closing provisions as a percentage of REIL and PPL increased to 73% from 68% at the end of 2003.



**Analysis of specific provisions**

The table below shows specific provisions by industry and geographic area.

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| **Industry:** | | | |
| Finance | 66 | 65 | 125 |
| Individuals  home mortgages | 46 | 37 | 67 |
|  other | 1,617 | 1,159 | 955 |
| Other commercial and industrial | 1,919 | 2,095 | 2,176 |
| | 3,648 | 3,356 | 3,323 |
| **Geography:** | | | |
| UK | 2,738 | 2,507 | 2,615 |
| US | 646 | 609 | 556 |
| Europe | 262 | 224 | 110 |
| Rest of the World | 2 | 16 | 42 |
| | 3,648 | 3,356 | 3,323 |

Notes:
(1) Excludes specific provisions against loans and advances to banks of £6 million (2003  £7 million; 2002  £7 million).
(2) The geographic analysis is based on location of office. The UK includes domestic transactions and transactions conducted through the offices in the UK which service international banking transactions.

**Amounts written off and recovered**

The table below shows the amounts written off by industry and geographical area.

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| **Industry:** | | | |
| Finance | 20 | 66 | 44 |
| Individuals  home mortgages | 4 | 2 | 2 |
|  other | 676 | 415 | 391 |
| Other commercial and industrial | 768 | 1,036 | 598 |
| | 1,468 | 1,519 | 1,035 |

| | | | |
|---|---|---|---|
| **Geography:** | | | |
| UK | 1,109 | 1,333 | 803 |
| US | 292 | 156 | 164 |
| Europe | 54 | 15 | 40 |
| Rest of the World | 13 | 15 | 28 |
| Total amounts written off | 1,468 | 1,519 | 1,035 |

Notes:
(1) Excludes amounts written off in respect of banks of nil (2003 — nil; 2002 — £1 million).
(2) The geographic analysis is based on location of office. The UK includes domestic transactions and transactions conducted through the offices in the UK which service international banking transactions.

The following table shows amounts previously written off and subsequently recovered during the year by industry and geographical area.

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| **Industry:** | | | |
| Finance | 4 | 1 | — |
| Individuals — other | 105 | 42 | 41 |
| Other commercial and industrial | 38 | 29 | 22 |
| | 147 | 72 | 63 |
| **Geography:** | | | |
| UK | 88 | 38 | 37 |
| US | 46 | 25 | 21 |
| Europe | 4 | 4 | 4 |
| Rest of the World | 9 | 5 | 1 |
| Total recoveries | 147 | 72 | 63 |

Notes:
(1) The geographic analysis is based on location of office. The UK includes domestic transactions and transactions conducted through the offices in the UK which service international banking transactions.



## **Operating and financial review** continued

### Liquidity risk

Liquidity management within the Group focuses on both overall balance sheet structure and the control, within prudent limits, of risk arising from the mismatch of maturities across the balance sheet and from undrawn commitments and other contingent obligations.

The management of liquidity risk within the Group is undertaken within limits and other policy parameters set by GALCO, who review monthly and receive, on an exception basis, reports detailing compliance with those policy parameters. A weekly report is also provided to the GEMC. Compliance is monitored and co-ordinated daily under the stewardship of the Group Treasury function, both in respect of internal policy and the regulatory requirements of the FSA. Detailed liquidity position reports are compiled each day by Group Treasury and reviewed daily and weekly with Financial Markets, who manage day-to-day and intra-day market execution within the policy parameters set.

In addition to their consolidation within the Group's daily liquidity management process, it is also the responsibility of all Group subsidiaries and branches outside the UK to ensure compliance with any separate local regulatory liquidity requirements where applicable.

The structure of the Group's balance sheet is managed to maintain substantial diversification, to minimise concentration across its various deposit sources, and to contain the level of reliance on total and net short-term wholesale sources of funds within prudent levels.

The short-term maturity structure of the Group's assets and liabilities is also managed on a daily basis to ensure that contractual cash flow obligations, and potential cash flows arising from undrawn commitments and other contingent obligations, can be met as they arise from day to day, either from cash inflows from maturing assets, new borrowing or the sale or repurchase of debt securities held.

Short-term liquidity risk is managed on a consolidated basis for the whole Group excluding the activities of Citizens and insurance businesses, which are subject to regulatory regimes that necessitate the separate management of liquidity.

Internal liquidity mismatch limits are set for all other subsidiaries and non-UK branches which have material local treasury activities in external markets, to ensure those activities do not compromise daily maintenance of the Group's overall liquidity risk position within the Group's policy parameters.

The level of large deposits taken from banks, corporate customers, non-bank financial institutions and other customers and significant cash outflows therefrom are also reviewed to monitor concentrations and identify any adverse trends.

The degree of maturity mismatch within the overall long-term structure of the Group's assets and liabilities is also managed within internal policy limits, to ensure that term asset commitments may be funded on an economic basis over their life. In managing its overall term structure, the Group analyses and takes into account the effect of retail and corporate customer behaviour on actual asset and liability maturities where they differ materially from the underlying contractual maturities.

The Group also periodically undertakes stress tests and sensitivity analysis to analyse the potential impact on its liquidity risk. Contingency plans are maintained to anticipate and respond to any approaching or actual material deterioration in market conditions.



*Sources of funding*

Excluding capital and other liabilities, customer accounts continue to provide a majority of the Group's funding and represent a well diversified and stable source of funds from a wide range of retail, corporate and non-bank institutional customers.

| | 2004 £m | % | 2003 £m | % | 2002 £m | % |
|---|---|---|---|---|---|---|
| Customer accounts (excluding repos): | | | | | | |
| Repayable on demand | 170,032 | 36 | 141,560 | 39 | 127,320 | 39 |
| Time deposits | 72,896 | 15 | 68,382 | 19 | 66,781 | 21 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total customer accounts (excluding repos) | 242,928 | 51 | 209,942 | 58 | 194,101 | 60 |
| Repo agreements with customers | 42,134 | 9 | 27,021 | 7 | 25,060 | 8 |
| Deposits by banks (excluding repos) | 55,739 | 12 | 40,279 | 11 | 34,623 | 11 |
| Repo agreements with banks | 43,342 | 9 | 27,044 | 8 | 20,097 | 6 |
| Debt securities in issue | 58,960 | 13 | 41,016 | 11 | 33,938 | 10 |
| Short positions | 28,923 | 6 | 19,128 | 5 | 16,381 | 5 |
| Total | 472,026 | 100 | 364,430 | 100 | 324,200 | 100 |

Customer accounts, excluding repo agreements, grew by £32,986 million (16%), and represent 51% of the Groups funding excluding capital and other liabilities. Excluding the Charter One acquisition the growth would have been £18,381 million (9%). The proportion of funding from wholesale sources has increased reflecting the higher rate of growth in customer loans and advances (excluding reverse repos), up £65,123 million (28%)  £48,405 million (21%) excluding Charter One.

Repo agreements with corporate and institutional customers are undertaken primarily by RBS Greenwich Capital in the US and by Financial Markets. Repo activity with customers represented 9% of the Groups funding excluding capital and other liabilities at 31 December 2004.

Deposits by banks including repos increased by £31,758 million (£27,240 million excluding Charter One) to represent 21% of the Groups funding, excluding capital and other liabilities. Deposits by banks are taken from a wide range of counterparties, with the largest single depositor continuing to represent less than 1% of the Groups total funding.

Debt securities in issue increased by £17,944 million to represent 13% of the Groups funding, excluding capital and other liabilities, at 31 December 2004. Total debt securities in issue at 31 December 2004 includes £9,589 million (2003 £9,187 million) with a maturity of over one year, reflecting the activity of the Group in raising term funds through its Euro and US Medium Term Note programmes and other term issues.

The Group remains well placed to access various wholesale funding sources from a wide range of counterparties and markets, and the changing mix evident between customer repos, deposits by banks and debt securities in issue primarily reflects comparative pricing, maturity considerations and investor/ counterparty demand rather than any material perceived trend.



## **Operating and financial review** continued

**Liquidity risk** (continued)

*Customer lending and customer accounts*

Net customer lending rose by £32,137 million as the growth in loans and advances to customers exceeded the growth in customer accounts. Structural liquidity risk continues to be maintained within the Groups policy parameters.

| | 2004<br>£m | 2003<br>£m | 2002<br>£m |
|---|---|---|---|
| Loans and advances to customers (gross, excluding reverse repos) | 297,507 | 232,384 | 205,303 |

| | | | |
|---|---|---|---|
| Customer accounts (excluding repos) | 242,928 | 209,942 | 194,101 |
| Customer lending less customer accounts | 54,579 | 22,442 | 11,202 |
| Customer accounts as % of loans and advances to customers (excluding repos) | 81.7% | 90.3% | 94.5% |

In prevailing economic conditions and with interest rates at relatively low historical levels in the UK, US and Europe, it is anticipated that the growth in demand for further borrowing by customers may, in the medium term, continue to exceed customer deposits received, thus increasing net customer lending further and increasing gradually over time the Group's dependence on the wholesale market for funding. The Group has evaluated a range of balance sheet management strategies to address the consequent impact on its liquidity risk position and has developed and implemented plans to contain that within its normal prudent liquidity risk policy parameters.



*Sterling liquidity*

Over 47% of the Group's total assets are denominated in sterling. The FSA requires the Group, on a consolidated basis, to maintain daily a minimum ratio of 100% between:

1. a stock of qualifying high quality liquid assets (primarily UK and EU government securities, treasury bills, and cash held in branches) and

2. the sum of:

    sterling wholesale net outflows contractually due within 5 working days (offset up to a limit of 50%, by 85% of sterling certificates of deposit held which mature beyond five working days); and

    5% of retail deposits with a residual contractual maturity of five working days or less.

The Group has exceeded the minimum ratio requirement throughout 2004.

The FSA also sets an absolute minimum level for the stock of qualifying liquid assets that the Group is required to maintain each day. The Group has exceeded that minimum stock requirement at all times during 2004.

The Group's operational processes are actively managed to ensure that both the minimum sterling liquidity ratio and the minimum stock requirement are achieved or exceeded at all times.

*Liquidity in non-sterling currencies*

For non-sterling currencies, no specific regulatory liquidity requirement is set for the Group by the FSA. However, the importance of managing prudently the liquidity risk in its non-sterling activities is recognised and the Group manages its non-sterling liquidity risk daily within net mismatch limits set for the 0-8 calendar day and 0-1 month periods as a percentage of the Group's total deposit liabilities.

In measuring its non-sterling liquidity risk, due account is taken of the marketability within a short period of the wide range of debt securities held. Appropriate adjustments are applied in each case, dependent on various parameters, to determine the Group's ability to realise cash at short notice via the sale or repo of such marketable assets if required to meet unexpected outflows.

The level of contingent risk from the potential drawing of undrawn or partially drawn commitments, back-up lines, standby lines and other similar facilities is also actively monitored and reflected in the measures of the Group's non-sterling liquidity risk. Particular attention is given to the US$ commercial paper market and the propensity of the Group's corporate counterparties (who are active in raising funds from that market) to switch to utilising facilities offered by the Group in the event of either counterparty specific difficulties or a significant widening of interest spreads generally in the commercial paper market.

The Group also provides liquidity back-up facilities to both its own conduits and certain other conduits which take funding from the US$ commercial paper market. Limits sanctioned for such facilities totalled less than £7,500 million at 31 December 2004. The short-term contingent liquidity risk in providing such back-up facilities is also mitigated by the spread of maturity dates of the commercial paper taken by the conduits.

The Group has operated within its non-sterling liquidity policy mismatch limits at all times during 2004 and operational processes are actively managed to ensure that will continue to be the case going forward.

Contingency plans are also maintained to enable the Group to respond effectively to unforeseen market liquidity or major payment systems problems that may emerge from time to time.



---

## **Operating and financial review** continued

### Market risk

The Group is exposed to market risk because of positions held in its trading portfolios and its non-trading business including the Group's treasury operations. The Group manages the market risk in its trading and treasury portfolios through its market risk management framework, which is based on value-at-risk ('VaR') limits, together with, but not limited to, stress testing, scenario analysis, and position and sensitivity limits. Stress testing measures the impact of abnormal changes in market rates and prices on the fair value of the Group's trading portfolios. GEMC approves the high-level VaR and stress limits for the Group. The Group market risk function, independent from the Group's trading businesses, is responsible for setting and monitoring the adequacy and effectiveness of the Group's market risk management processes.

*Value-at-risk*

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. For internal risk management purposes, the Group's VaR assumes a time horizon of one day and a confidence level of 95%. The Group uses historical simulation models in computing VaR. This approach, in common with many other VaR models, assumes that risk factor changes observed in the past are a good estimate of those likely to occur in the future and is, therefore, limited by the relevance of the historical data used. The Group's method, however, does not make any assumption about the nature or type of underlying loss distribution. The Group typically uses the previous two years of market data. The Group's VaR should be interpreted in light of the limitations of the methodology 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 the 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.

*Trading*

The principal focus of the Group's trading activities is client facilitation - providing products to the Group's client base at competitive prices. The Group also undertakes: market making  quoting firm bid (buy) and offer (sell) prices with the intention of profiting from the spread between the quotes; arbitrage entering into offsetting positions in different but closely related markets in order to profit from market imperfections; and proprietary activity  taking positions in financial instruments as principal in order to take advantage of anticipated market conditions. The main risk factors are interest rates, credit spreads and foreign exchange. Financial instruments held in the Group's trading portfolios include, but are not limited to, debt securities, loans, deposits, securities sale and repurchase agreements and derivative financial instruments (futures, forwards, swaps and options). For a discussion of the Group's accounting policies for, and information with respect to, its exposures to derivative financial instruments, see Accounting policies and Note 39 on the accounts.

The VaR for the Group's trading portfolios segregated by type of market risk exposure is presented in the table below.

| | 2004 | | | | 2003 | | | |
|---|---|---|---|---|---|---|---|---|
| | Average £m | Period end £m | Maximum £m | Minimum £m | Average £m | Period end £m | Maximum £m | Minimum £m |
| **Trading** | | | | | | | | |
| Interest rate | 11.5 | 11.2 | 16.5 | 6.9 | 9.4 | 7.4 | 14.5 | 5.7 |
| Currency | 1.1 | 1.2 | 2.7 | 0.5 | 1.3 | 0.8 | 2.5 | 0.7 |
| Equity | 0.6 | 0.2 | 2.0 | 0.2 | 0.5 | 0.4 | 1.4 | 0.2 |
| Diversification | | (2.3) | | | | (1.2) | | |
| Total trading VaR | 10.8 | 10.3 | 16.0 | 6.4 | 9.4 | 7.4 | 14.2 | 5.6 |

54

*Non-trading*

The principal market risks arising from the Group's non-trading activities are interest rate risk, currency risk and equity risk. Treasury activity and mismatches between the repricing of assets and liabilities in its retail and corporate banking operations account for most of the non-trading interest rate risk. Non-trading currency risk derives from the Group's investments in overseas subsidiaries, associates and branches. The Group's venture capital portfolio, investments held by its general insurance business and its strategic equity investments are the principal sources of non-trading equity price risk. The Group's portfolios of non-trading financial instruments mainly comprise loans (including finance leases), debt securities, equity shares, deposits, certificates of deposits and other debt securities issued, loan capital and derivatives. To reflect their distinct nature, the Group's long-term assurance assets and liabilities attributable to policyholders have been excluded from these market risk disclosures.

 *Interest rate risk*

Non-trading interest rate risk arises from the Group's treasury activities and retail and corporate banking businesses.

**Treasury**

The Group's treasury activities include its money market business and the management of internal funds flow within the Group's businesses. Money market portfolios include cash instruments (principally debt securities, loans and deposits) and related hedging derivatives. VaR for the Group's treasury portfolios, which relates mainly to interest rate risk was £5.5 million at 31 December 2004 (2003  £8.1 million). During the year the maximum VaR was £8.6 million (2003  £11.0 million), the minimum £5.5 million (2003  £5.6 million) and the average £7.0 million

(2003  £8.3 million).

***Retail and corporate banking***

Structural interest rate risk arises in these activities where assets and liabilities have different repricing dates. It is the Groups policy to minimise the sensitivity of net interest income to changes in interest rates and where interest rate risk is retained to ensure that appropriate resources, measures and limits are applied.

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

A static maturity gap report is produced as at the month-end for each division, in each functional currency based on the behaviouralised repricing for each product. It is Group policy to include in the gap report, non-financial assets and liabilities, mainly tangible fixed assets and the Groups capital and reserves, spread over medium and longer term maturities. This report also includes hedge transactions, principally derivatives.

Any residual non-trading interest rate exposures are controlled by limiting repricing mismatches in the individual balance sheets. Potential exposures to interest rate movements in the medium to long term are measured and controlled using a version of the same VaR methodology that is used for the Groups trading portfolios but without discount factors. Net interest income exposures are measured and controlled in terms of sensitivity over time to movements in interest rates.



## **Operating and financial review** continued

**Market risk** (continued)

*Non-trading (continued)*

Non-trading interest rate VaR

Non-trading interest rate VaR for the Groups treasury and retail and corporate banking activities was £72.4 million at 31 December 2004 (2003  £78.1 million) with the major exposure being to changes in longer term US dollar interest rates. During the year, the maximum VaR was £89.7 million (2003 £78.1 million), the minimum £51.5 million (2003  £29.9 million) and the average £71.2 million (2003  £51.7 million).

Citizens was the main contributor to the Groups non-trading interest rate VaR. It invests its surplus retail deposits in a portfolio of highly rated and liquid investments principally mortgage-backed securities. This balance sheet management approach is common for US retail banks where mortgages are originated and then sold to Federal agencies for funding through the capital markets. The significant increase in VaR during 2003 and 2004 reflects substantial growth in retail deposits in Citizens and asset growth in home equity loans and mortgage backed securities both organically and through acquisition. VaR, like all interest rate risk measures, has its limitations when applied to retail banking books and the management of Citizens interest rate exposures involves a number of other interest rate risk measures and related limits. Two measures that are reported both to Citizens ALCO and Board are:

- the sensitivity of their net interest income to a series of parallel movements in interest rates; and
- economic value of equity (EVE) limits.

These limits are set to parallel movements of +/-1% and +/-2%. The EVE methodology captures deposit re-pricing strategies and the embedded option risks that exists within both the investment portfolio of mortgage-backed securities and the consumer loan portfolio. EVE is the present value of the cash flows generated by the current balance sheet. EVE sensitivity to a 2% parallel movement upwards and downwards in US interest rates is shown below.

| | Percent increase/(decrease) in Citizens EVE | |
|---|---|---|
| | 2% parallel upward movement in US interest rates | 2% parallel downward movement in US interest rates (no negative rates allowed) |
| **2004** | % | % |
| Period end | (9.2) | (4.4) |
| Maximum | (12.6) | (18.5) |
| Minimum | (5.2) | (4.4) |
| Average | (9.3) | (9.2) |

| | Percent increase/(decrease) in Citizens EVE | |
|---|---|---|
| | 2% parallel upward movement in US interest rates | 2% parallel downward movement in US interest rates (no negative rates allowed) |
| **2003** | % | % |
| Period end | (9.4) | (8.8) |
| Maximum | (11.4) | (14.2) |
| Minimum | 3.2 | (0.6) |
| Average | (4.4) | (6.4) |

At Group level, the other major structural interest rate risk arises from a low interest rate environment, particularly in sterling, sustained for a number of years. In such a scenario deposit pricing may reach effective floors below which it is not reasonable to reduce rates further whilst variable rate asset pricing continues to decline. A sustained low rate scenario would also generate progressively reduced income from the medium and long term hedging of non-interest bearing liabilities. GALCO regularly reviews the impact of successive declines in rates to ensure that appropriate risk management strategies are employed. This may involve execution of derivatives, product development and tactical pricing changes.

Note 40 on the accounts includes, on pages 121 and 122, tables that summarise the Group's interest rate sensitivity gap for its non-trading book at 31 December 2004 and 31 December 2003. The tables show the contractual re-pricing for each category of asset, liability and for off-balance sheet items and do not reflect the behaviouralised repricing used in the Group's asset and liability management methodology and the non-trading interest rate VaR presented above.



*Currency risk*

The Group does not maintain material non-trading open currency positions other than the structural foreign currency translation exposures arising from its investments in overseas subsidiaries and associated undertakings and their related currency funding. The Group’s policy in relation to structural positions is to match fund the structural foreign currency exposure arising from net asset value, including goodwill, in overseas subsidiaries, equity accounted investments and branches, except where doing so would materially increase the sensitivity of either the Group’s or the subsidiary’s regulatory capital ratios to currency movements. The policy requires structural foreign exchange positions to be reviewed regularly by GALCO. Gains or losses on foreign currency investments net of any gains or losses on related foreign currency funding or hedges are recognised in the statement of total recognised gains and losses.

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

| **2004** | Net investments in overseas operations £m | Foreign currency borrowings hedging net investments £m | Structural foreign currency exposures £m |
|---|---|---|---|
| US dollar | 12,367 | 6,580 | 5,787 |
| Euro | 2,086 | 1,349 | 737 |
| Swiss franc | 398 | 392 | 6 |
| Other non-sterling | 116 | 112 | 4 |
| | 14,967 | 8,433 | 6,534 |
| **2003** | | | |
| US dollar | 5,329 | 5,198 | 131 |
| Euro | 1,422 | 826 | 596 |
| Swiss franc | 357 | 357 | – |
| Other non-sterling | 118 | 114 | 4 |
| | 7,226 | 6,495 | 731 |

The US dollar open structural foreign currency exposure reflects the action taken to mitigate the effect of the acquisition of Charter One on the Group’s capital ratios. The structural foreign currency exposure in euros is principally due to Ulster Bank running an open structural foreign exchange position to minimise the sensitivity of its capital ratios to possible movements in the Euro exchange rate against Sterling.

*Equity risk*

Non-trading equity risk arises principally from the Group’s strategic investments, its venture capital activities and its general insurance business.

VaR is not an appropriate risk measure for the Group’s venture capital investments, which comprise a mix of quoted and unquoted investments, or its portfolio of strategic investments. At 31 December 2004, equity shares held as investment securities had a book value of £2,440 million (2003 – £1,821 million) and a valuation of £2,882 million (2003 – £2,238 million).

**Insurance risk**

The Group is exposed to insurance risk, either directly through its businesses or through using insurance as a tool to reduce other risk exposures:

- Insurance is a source of risk where the Group sells and underwrites general insurance and life assurance. The essence of an insurance contract is the transfer of risk from the policyholder to the insurer for the payment of a sum on the occurrence of an insured event.

  The management of insurance risk is overseen by a Pricing Committee that meets weekly to review underwriting factors, e.g. car groups, terms and conditions, claims experience. This is supplemented by a range of system controls and processes including risk acceptance, with regular independent reviews of underwriting across the business. Primary focus is on high volume and relatively straightforward products for example home and motor. This facilitates the generation of comprehensive underwriting and claims data, which is used to monitor and accurately price the risks accepted. This attention to data analysis is reinforced by tight controls on costs and claims handling procedures.

  Underwriting concentrations and catastrophe exposure are reviewed and, where necessary, mitigated by reinsurance which is spread across a number of reinsurers. Reviews of the Groups general insurance reserves by external actuaries are conducted annually.

  Investment strategy reflects the maturity of underwriting liabilities and is governed through Investment Management Committees, with involvement and oversight from Group Treasury. The Groups underwriting experience, the level of retained risk and solvency are monitored at divisional and Group level.

- The Insurance Sourcing Department is responsible for the Group-wide purchase of insurance as a means of reducing other risk exposures. As such, it is a key component of the Groups risk management process and reports its activities to the GEMC.

**Enterprise risk**

In order to adequately identify and manage the full range of Enterprise risk, the Group has separately defined operational and external risk:

Operational risk is defined as the risk arising from within the organisation from:

- People  risks arising from an inappropriate level of staff, inadequately skilled or managed people.

- Process  risk caused by inadequate or failed internal processes.

- Systems  risks of inadequately designed or maintained systems.

- Assets  risk of damage, misappropriation or theft of the Groups physical, logical and intangible assets.

External risk is defined as the risk arising from outside of the organisation in three main areas:

- Business  risks arising from product performance, competitor activity, supplier unreliability or customer activity.

- Political  risks caused by political unrest or uncertainty, activity by public interest groups or extremists, and non- compliance with, or changes to, current legislation.

- Environment  risks arising due to demographic, macroeconomic, technical, cultural or environmental change.

Enterprise risk also includes the potential or actual impact on corporate reputation arising from any of the Group's activities.

Enterprise risk management is achieved through monitoring the Group's exposure to direct or indirect loss using a range of policies, procedures, data, analytical tools and reporting techniques. In particular, Group-wide risk management processes ensure that Enterprise risk issues are quickly escalated and resolved, that the risks inherent in new products are fully evaluated, and that emerging external risks are actively monitored.

Operational risk exposures and loss events for each division are captured through monthly Risk and Control returns, which provide details on the change of risk exposures for each risk category in the light of improving/deteriorating trends and the risk profile of each division.

58

---

## Governance

Contents


| | |
|---|---|
| **60** | Board of directors and secretary |
| **62** | Report of the directors |
| **66** | Corporate governance |
| **70** | Directors' remuneration report |
| **80** | Directors' interests in shares |
| **81** | Statement of directors' responsibilities |


59

---

## Board of directors and secretary

60

**Chairman**
Sir George Mathewson (age 64)
CBE, DUniv, LLD, FRSE, FCIBS
**C (Chairman), N (Chairman)**

Appointed to the Board in September 1987 and as Chairman in April 2001, Sir George Mathewson has a wide background in finance, technology and management and spent some of his career in the United States. He became Group Chief Executive in January 1992 and in March 2000, he was appointed Executive Deputy Chairman. He is a director of The Scottish Investment Trust PLC and the Institute of International Finance, Inc. He is also vice-president of the International Monetary Conference, a member of the Advisory Committee of Bridgepoint Capital Limited and a member of the Financial Reporting Council. He was chief executive of the Scottish Development Agency from 1981 to 1987 and is a former president of the British Bankers Association.

**Vice-chairmen**
Lord Vallance of Tummel (age 61)
FCIBS
**C**

Appointed to the Board in January 1993 and as Vice-Chairman in March 1994, Lord Vallance is an experienced businessman who is currently chairman of the European Services Forum and a director of the supervisory board of Siemens AG. He is also a member of the European Advisory Council of the Rothschild Group and the European Advisory Committee of the NYSE. He held a range of other positions including president of the CBI, chairman of British Telecommunications Plc and deputy chairman of the Financial Reporting Council. He was also a member of the board of directors of the Mobil Corporation.

Sir Angus Grossart (age 67)
CBE, DBA, LLD, FRSE, DL, FCIBS, D.Litt
**C**

Appointed to the Board in September 1985 and as Vice-Chairman in April 1996, Sir Angus Grossart is an advocate and Chartered Accountant with a career in merchant banking. He is chairman and chief executive of Noble Grossart Limited. His directorships of public companies include Scottish and Newcastle Plc and Trinity Mirror Plc. He is a trustee of the National Heritage Memorial Fund and a former chairman of the trustees of the National Galleries of Scotland. He has also served on the boards of a wide range of other companies in the UK, the USA and Canada.

**Executive directors**
Sir Fred Goodwin (age 46)
DUniv, FCIBS, FCIB, LLD
**Group Chief Executive**
**C**

Appointed to the Board in August 1998, Sir Fred Goodwin is a Chartered Accountant. He was formerly chief executive and director, Clydesdale Bank PLC and Yorkshire Bank PLC. He is chairman of The Princes Trust and a former president of the Chartered Institute of Bankers in Scotland.

Lawrence Fish (age 60)
**Chairman, President and Chief Executive Officer of Citizens Financial Group, Inc.**

Appointed to the Board in January 1993, Lawrence Fish is an American national. He is a career banker and was a director of the Federal Reserve Bank of Boston. He is a trustee of The Brookings Institution and a director of the Financial Services Roundtable, Textron Inc., and numerous community organisations in the USA.

Gordon Pell (age 54)
FCIBS, FCIB
**Chairman, Retail Banking and Wealth Management**

Appointed to the Board in March 2000, Gordon Pell was formerly group director of Lloyds TSB UK Retail Banking before joining National Westminster Bank Plc as a director in February 2000 and then becoming chief executive, Retail Banking. He is currently also a director of Race for Opportunity and Southampton University Development Trust.

Fred Watt (age 44)
FCIBS
**C**
**Group Finance Director**

Appointed to the Board in September 2000, Fred Watt is a Chartered Accountant. He was formerly finance director of Wassall plc.

**Non-executive directors**
Colin Buchan* (age 50)
**A (Acting Chairman), R**

Appointed to the Board in June 2002, Colin Buchan was educated in South Africa and spent the early part of his career in South Africa and the Far East. He has considerable international investment banking experience, as well as experience in very large risk management in the equities business. He was formerly a member of the group management board of UBS AG and head of equities of UBS Warburg. He is vice-chairman of Standard Life Investments Limited and a director of Merrill Lynch World Mining Trust Plc, Merrill Lynch Gold Limited, Royal Scottish National Orchestra Society Limited, UBS Securities Canada Inc. and World Mining Investment Company Limited.

Jim Currie* (age 63)
D.Litt
**R**

Appointed to the Board in November 2001, Jim Currie is a highly experienced senior international civil servant who spent many years working in Brussels and Washington. He was formerly director general at the European Commission with responsibility for the EU's environmental policy and director general for Customs and Excise and Indirect Taxation. He is also a director of British Nuclear Fuels PLC and Total Holdings UK Limited, an international adviser to Eversheds and a consultant to Butera & Andrews UK Limited.

Archie Hunter* (age 61)
**A (Chairman Designate)**

Appointed to the Board in September 2004, Archie Hunter is a Chartered Accountant. He was Scottish senior partner of KPMG between 1992 and 1999 and President of The Institute of Chartered Accountants of Scotland in 1997/8. He has extensive professional experience in the UK and North and South America. He is currently chairman of Macfarlane Group plc, a director of Edinburgh US Tracker Trust plc, Convenor of Court at the University of Strathclyde and a governor of the Beatson Cancer Research Institute.

Charles "Bud" Koch (age 58)

Appointed to the Board in September 2004, Bud Koch is an American national. He has extensive professional experience in the USA and is currently chairman of the board of the Federal Home Loan Bank of Cincinnati, chairman of the board of John Carroll University and a trustee of Case Western Reserve University. He was the chairman, president and chief executive officer of Charter One Financial, Inc. and its wholly owned subsidiary, Charter One Bank, N.A between 1973 and 2004.

Joe MacHale* (age 53)
**A**

Appointed to the Board in September 2004, Joe MacHale is currently a non-executive director and chairman of the audit committee of Morgan Crucible plc and a trustee of MacMillan Cancer Relief. He held a number of senior executive positions with J P Morgan between 1979 and 2001 and was latterly chief executive of J P Morgan Europe, Middle East and Africa Region.

Eileen Mackay* (age 61)
CB, FCIBS
**A, R**

Appointed to the Board in May 1996, Eileen Mackay is a former senior UK civil servant who held posts in Scotland, HM Treasury and the Cabinet Office and was principal finance officer at The Scottish Office. She is a director of Edinburgh Investment Trust plc, Scottish Financial Enterprise and The British Library. She is also chairman of the trustees of the David Hume Institute and a trustee of the Carnegie Trust for the Universities of Scotland.

Iain Robertson (age 59)
CBE, FCIBS
**Chairman, Corporate Banking and Financial Markets**

Appointed to the Board in January 1993, Iain Robertson is a Chartered Accountant. He is chairman of British Empire Securities and General Trust plc, Cairn Capital Limited and BT Scotland, and a director of John Menzies plc.

Sir Steve Robson* (age 61)
**A**

Appointed to the Board in July 2001, Sir Steve Robson is a former senior UK civil servant, who had responsibility for a wide variety of Treasury matters. His early career included the post of Private Secretary to the Chancellor of the Exchequer and secondment to ICFC, (now 3i). He was also a Second Permanent Secretary of HM Treasury, where he was managing director of the Finance and Regulation Directorate. He is a non-executive director of Cazenove Group Plc, Xstrata Plc and Partnerships UK plc, and a member of the Chairman's Advisory Committee of KPMG.

Bob Scott* (age 63)
CBE, FCIBS
**C, N, R (Chairman)**

Appointed to the Board in January 2001, Bob Scott is an Australian national. He is the senior independent director. Bob Scott has many years experience in the international insurance business and played a leading role in the consolidation of the UK insurance industry. He is a former group chief executive of CGNU plc and chairman of the board of the Association of British Insurers. He is chairman of Yell Group plc, a non-executive director of Swiss Reinsurance Company (Zurich), Jardine Lloyd Thompson Group plc and Focus Wickes Group Limited, and a trustee of the Crimestoppers Trust.

Peter Sutherland* (age 58)
KCMG
**N**

Appointed to the Board in January 2001, Peter Sutherland is an Irish national. He is a former attorney general of Ireland and from 1985 to 1989 was the European commissioner responsible for competition policy. He is chairman of BP Plc and Goldman Sachs International and a director of Investor AB. He was formerly chairman of Allied Irish Bank and a director general of GATT and the World Trade Organisation.

**Group Secretary and General Counsel**
Miller McLean (age 55)
FCIBS
**C**

Miller McLean was appointed Group Secretary in August 1994. He is a trustee of the Industry and Parliament Trust, a non-executive chairman of The Whitehall and Industry Group and a director of The Scottish Parliament and Business Exchange.

**A** member of the Audit Committee
**C** member of the Chairman's Advisory Group
**N** member of the Nominations Committee
**R** member of the Remuneration Committee
***** independent non-executive director



## Report of the directors

The directors have pleasure in presenting their report together with the audited accounts for the year ended 31 December 2004.

*Profit and dividends*

The profit attributable to the ordinary shareholders of the company for the year ended 31 December 2004 amounted to £4,256 million (after preference dividends of £256 million) compared with £2,254 million for the year ended 31 December 2003, as set out in the consolidated profit and loss account on page 89.

An interim dividend of 16.8p per ordinary share was paid on 8 October 2004 totalling £529 million (2003 – £431 million). The directors now recommend that a final dividend of 41.2p per ordinary share totalling £1,308 million (2003 – £1,059 million) be paid on 3 June 2005 to members on the register at the close of business on 11 March 2005. If this recommendation is approved by shareholders at the annual general meeting on 20 April 2005, the retained profit for the year will amount to £2,419 million (2003 – £764 million). Subject to the approval of the dividend by shareholders at the annual general meeting, shareholders will be offered the choice of taking ordinary shares in lieu of cash in respect of the final dividend.

*Activities and business review*

The company is a holding company owning the entire issued ordinary share capital of the Royal Bank, the principal direct operating subsidiary undertaking of the company. The "Group" comprises the company and all its subsidiary and associated undertakings, including the Royal Bank and NatWest. The Group is engaged principally in providing a comprehensive range of banking, insurance and other financial services. Details of the principal subsidiary undertakings of the company are shown in Note 17. A review of the business for the year to 31 December 2004, of recent events and of likely future developments is contained in the Operating and financial review.

*Business developments*

In January 2004, Citizens completed the acquisition of Thistle Group Holdings, Co., the holding company of Pennsylvania-based Roxborough Manayunk Bank.

In January 2004, Ulster Bank completed the acquisition of First Active plc.

In March 2004, Citizens completed the purchase of the credit card portfolio of People's Bank in the US.

In May 2004, NatWest completed the acquisition of Bibit, a leading international internet payment specialist.

In August 2004, Citizens completed the acquisition of Charter One Financial, Inc.

In September 2004, Citizens completed the acquisition of Lynk Systems Inc, a US based merchant acquiring business.

*Going concern*

The directors are satisfied that the Group has adequate resources to continue in business for the foreseeable future. For this reason, they continue to adopt the 'going concern' basis for preparing the accounts.

*Ordinary share capital*

During the year ended 31 December 2004, the ordinary share capital was increased by the following issues:

(a) 165 million ordinary shares placed at an issue price of £16.20 per share;

(b) 12.9 million ordinary shares allotted as a result of the exercise of options under the company's executive, sharesave and option 2000 schemes and a further 5.6 million ordinary shares allotted in respect of the exercise of options under the NatWest executive and sharesave schemes which had been exchanged for options over the company's shares following the acquisition of NatWest in 2000;

(c) 23.4 million ordinary shares allotted in lieu of cash dividends; and

(d) 2.4 million ordinary shares allotted under the company's employee share ownership plan.

Details of the authorised and issued ordinary share capital at 31 December 2004 are shown in Note 33.

*Preference share capital*

Details of issues of preference shares during the year and the authorised and issued share capital at 31 December 2004 are shown in Note 33.

*Trust preferred securities*

Details of issues of trust preferred securities by subsidiaries of the Group are shown in Note 32.

*Subordinated liabilities*

Details of issues and redemptions of dated and undated loan capital and the subordinated liabilities at 31 December 2004 are shown in Notes 30 and 31.



*Shareholdings*

As at 23 February 2005, the company had been notified of the following interests in its shares, in accordance with section 198 of the Companies Act 1985:

| | Number of shares | % held |
|---|---|---|
| Ordinary shares: | | |
| Cater Allen International | 107,628,711 | 3.42 |
| Legal & General Group plc | 98,761,695 | 3.40 |
| Barclays PLC | 93,254,320 | 3.14 |
| The Capital Group of Companies, Inc | 95,578,555 | 3.01 |
| 11% cumulative preference shares: | | |
| Guardian Royal Exchange Assurance plc | 129,830 | 25.97 |
| Windsor Life Assurance Company Limited | 51,510 | 10.30 |
| Mr S. J. and Mrs J. A. Cockburn | 30,810 | 6.16 |
| Cleaning Tokens Limited | 25,500 | 5.10 |

| | Number of shares | % held |
|---|---|---|
| 5 ½% cumulative preference shares: | | |
| Commercial Union Assurance plc | 91,429 | 22.86 |
| Mr P. S. and Mrs J. Allen | 86,999 | 21.75 |
| Bassett-Patrick Securities Limited* | 46,255 | 11.56 |
| E M Behrens Charitable Trust | 20,000 | 5.00 |
| Mrs Gina Wild | 19,800 | 4.95 |
| Trustees of The Stephen Cockburn Limited Pension Scheme | 19,879 | 4.97 |
| Miss Elizabeth Hill | 16,124 | 4.03 |
| Mr W. T. Hardison Jr. | 13,532 | 3.38 |
| Ms C. L. Allen | 13,200 | 3.30 |
| Ms J. C. Allen | 12,750 | 3.18 |

* Notification has been received on behalf of Mr A. W. R. Medlock and Mrs H. M. Medlock that they each have an interest in the holding of 5 ½% cumulative preference shares registered in the name of Bassett-Patrick Securities Limited noted above and that there are further holdings of 5,300 and 5,000 shares, respectively, of that class registered in each of their names.

*Directors*

The names and brief biographical details of the directors are shown on page 61. All directors, except:

- Archie Hunter and Joe MacHale, who were appointed to the Board on 1 September 2004,
- Bud Koch, who was appointed to the Board on 29 September 2004,
- Norman McLuskie, who retired from the Board on 23 August 2004, and
- Emilio Botin and Juan Inciarte, who resigned from the Board on 12 November 2004,

served throughout the year and to the date of signing of the financial statements.

Sir Angus Grossart, Lord Vallance and Iain Robertson will retire at the forthcoming annual general meeting. Jim Currie, Sir Fred Goodwin, Archie Hunter, Bud Koch, Joe MacHale and Sir Steve Robson will retire and offer themselves for election or re-election. Details of the service agreement for Sir Fred Goodwin are set out on page 74. No other director seeking election or re-election has a service agreement.

*Directors' interests*

The interests of the directors in the shares of the company at 31 December 2004 are shown on page 80. None of the directors held an interest in the loan capital of the company or in the shares and loan capital of any of the subsidiary undertakings of the company, during the period from 1 January 2004 to 23 February 2005.

*Employee proposition*

The Group recognises that the performance of its people is central to the successful delivery of its overall business strategy. Accordingly, the Group focuses on maintaining a compelling employee proposition that attracts, engages and then retains the best available talent. It is the breadth and depth of that employee talent which has cemented the Group's standing as one of the world's leading financial institutions.

*Employee recruitment*

To assist those within the Group responsible for recruitment, online toolkits have been developed in conjunction with interview skills training, which equip them effectively to recruit the best people for specific roles. In addition, the Group encourages movement within the organisation through the provision of an online appointments section which enables employees to apply for new or different roles throughout the Group.

The profile of the Group led to over 10,000 applications being received during its 2003/4 graduate campaign for some 200 places. The 2004 UK-based CBFM graduate intake, included 37 per cent Continental European entrants with an additional 21 Continental European graduates and interns placed within CBFM businesses in Frankfurt, Milan, Madrid and Paris. All applications were received online through the graduate website.

To complement this work a Group wide employee induction event was conducted, which provided opportunities to network with other new joiners and facilitated the exchange of ideas and information. Within the last year the Group rose 23 places to rank 15th in the Times Top 100 Graduate employers table.



---

## **Report of the directors** continued

*Employee reward*

Under Total Reward the Group offers one of the most comprehensive remuneration and benefits packages in the financial services sector, consisting of salary, bonus, share schemes and competitive pension benefits. Salary awards recognise both market competitor movements and individual performance, with the largest increases being directed towards high performers.

Through RBSelect, the Group's benefits choice programme, all UK employees have the flexibility to customise their remuneration and tailor it to their particular lifestyle needs. This includes the opportunity to access subsidised childcare vouchers, discounted personal insurance products and discounted shopping vouchers at a range of high street stores.

In addition, employees can participate in bonus incentive plans specific to their business and share in the Group's success through profit sharing, Buy As You Earn and Sharesave schemes, which align their interests with those of shareholders. UK employees participate in profit sharing that is directly related to the annual performance of the Group. For the last six years this has amounted to a further 10 percent of basic salary.

The Group provides pension plan membership for most employees in the UK and overseas. The largest plan is The Royal Bank of Scotland Group Pension Fund, which has over 80,000 employee members in the UK. Through this and a number of additional pension arrangements in the UK and overseas, the Group ensures that employees benefit from competitive pension provision as part of their Total Reward. The actuarial valuation of the main UK pension scheme as at 31 March 2004 resulted in a deficit of £1,994 million. To address this the Group made a special cash contribution of £750 million to the scheme in December 2004. It also increased its contribution rate to 21.5 percent of pensionable salaries with effect from April 2004.

*Employee learning and development*

The Group actively encourages professional development and lifelong learning and is committed to creating and providing experiences outside the workplace that benefit the employee, the community they work in and the Group. The Prince's Trust initiative, for example, enables employees to participate in volunteer and mentoring programmes and contributes to the Group's Community Investment and Corporate Responsibility aims.

The Group acknowledges the importance of developing and maintaining strong leadership capability across the organisation, proactively developing future leaders and creating succession plans for senior and executive management roles. A core component of this ongoing activity is the Executive Leadership Programme developed in conjunction with the Harvard Business School and the establishment of an on-site business school at the Group Headquarters at Gogarburn, Edinburgh which is due to open in Spring 2005. The introduction of emerging leader workshops, which included employee representatives from Citizens Bank, is further evidence of the Groups commitment to global executive development.

In addition, through Learning Awards, the Group provides financial incentives to employees who take the banking qualifications offered by the Chartered Institute of Bankers in Scotland and The Institute of Financial Services.

*Employee communication*

Employee engagement is encouraged through a transparent process of communication and consultation. This is achieved through a corporate Intranet, divisional magazines, team meetings led by line managers, briefings held by senior managers and regular dialogue with employees and employee representatives.

The Group Chief Executive and other senior Group executives regularly communicate directly with employees through Question Time style programmes, some of which are broadcast on the Groups internal television network. This is used to convey information ranging from annual and interim financial results to employee training and development issues.

*Employee consultation*

The Group recognises that the key to becoming (and remaining) an employer of choice is to ensure that employees are able to maximise their contribution to the Group. Each year an independent specialist company conducts a global Employee Opinion Survey on behalf of the Group to measure how employees feel about a number of important issues.

With an overall response rate of 84 percent (some 20 percent higher than the industry average) the Group remains confident that employees value the survey as a method of expressing their views and as a way of initiating change throughout the organisation. Since the last Group-wide survey in January 2003, there were significant improvements in 14 out of 15 question categories. The RBS Group performs very well against ISRs Global Financial Services comparison companies, which includes many of the Groups key competitors in the UK and abroad. The Group outperforms this comparison group in all but one category.

*Diversity*

The Group continues to participate in a range of programmes and activities designed to promote diversity and effective people management. Reflecting its commitment to a business model based on meritocracy and inclusiveness, the Group encourages employees to develop their full potential, irrespective of their race, gender, marital status, age, disability, religious belief, political opinion or sexual orientation.

The Group is also committed to ensuring that all prospective applicants for employment are treated fairly and equitably throughout the recruitment process. Our comprehensive resourcing standards cover the attraction and retention of individuals with disabilities. Reasonable adjustments are provided to support the applicant in the recruitment process where these are required. The Group provides reasonable workplace adjustments for new entrants into the Group and also for existing employees who become disabled during their employment.

*Health, safety, well being and security*

The health, safety, well being and security of employees and customers are of vital concern to the Group, which constantly reviews its position on policies in these areas to reflect current legislation and best practice. Furthermore, the Group focuses on ensuring that those policies are closely linked to the operational needs of the business.

*Corporate responsibility*

Business excellence requires that the Group meets changing customer, shareholder, investor, employee and supplier expectations. The Group believes that meeting high standards of environmental, social and ethical responsibility is key to the way it does business.

The Board regularly considers corporate responsibility issues and receives a formal report on these matters twice each year. Further details of the Groups corporate responsibility policies will be contained in the 2004 Corporate Responsibility Report.

*Code of ethics*

The Group has adopted a code of ethics that is applicable to all of the Groups employees and a copy is available upon request.

*Charitable contributions*

In 2004 the contribution to the Groups Community Investment programmes increased to £45.8 million (2003  £40.1 million). The total amount given for charitable purposes by the company and its subsidiary undertakings during the year ended 31 December 2004 was £20.1 million (2003  £14.7 million).

*Corporate governance*

The company is committed to high standards of Corporate governance. Details are given on pages 66 to 69.

*Political donations*

No political donations were made during the year.

At the annual general meeting in 2002 shareholders gave authority for the company and certain of its subsidiaries to make political donations and incur political expenditure up to a maximum aggregate sum of £675,000 as a precautionary measure in light of the wide definitions in The Political Parties, Elections and Referendums Act 2000, for a period of four years. These authorities have not been used and it is not proposed that the Groups longstanding policy of not making contributions to any political party be changed.

*Policy and practice on payment of creditors*

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

At 31 December 2004, the Groups trade creditors represented 27 days (2003  27 days) of amounts invoiced by suppliers. The company does not have any trade creditors.

*Auditors*

The auditors, Deloitte & Touche LLP, have indicated their willingness to continue in office. A resolution to re-appoint Deloitte & Touche LLP as the company’s auditor will be proposed at the forthcoming annual general meeting.

By order of the Board.

Miller McLean
*Secretary*
23 February 2005

The Royal Bank of Scotland Group plc is registered in Scotland No. 45551.



---

## Corporate governance

The company is committed to high standards of corporate governance, business integrity and professionalism in all its activities.

Throughout the year ended 31 December 2004, the company has complied with all of the provisions set out in the revised Combined Code issued by the Financial Reporting Council in July 2003 (the “Code”) except in relation to the authority reserved to the Board to make the final determination of the remuneration of the executive directors, which is explained below in the paragraph headed “Remuneration Committee”.

The company has also complied with the Smith Guidance on Audit Committees in all material respects.

Under the US Sarbanes-Oxley Act of 2002, enhanced standards of corporate governance and business and financial disclosure apply to companies, including the company, with securities registered in the US. The Group complies with all sections of the Sarbanes-Oxley Act of 2002 currently applicable.

*Board of directors*

The Board is the principal decision making forum for the company. It has overall responsibility for leading and controlling the company and is accountable to shareholders for financial and operational performance. The Board approves Group strategy and monitors performance. The Board has adopted a formal schedule of matters detailing key aspects of the company’s affairs reserved to it for its decision. This schedule is reviewed annually.

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

All directors participate in discussing strategy, performance and financial and risk management of the company and meetings of the Board are structured to allow open discussion.

The Board met 10 times during 2004 and was supplied with comprehensive papers in advance of each Board meeting covering the Group's principal business activities. Members of the executive management attend and make regular presentations as appropriate at meetings of the Board.

*Board balance and independence*

The Board currently comprises the Chairman, four executive directors and 12 non-executive directors. The Board functions effectively and efficiently and is considered to be of an appropriate size in view of the scale of the company and the diversity of its businesses. The directors provide the Group with the knowledge, mix of skills, experience and networks of contacts required. The Board Committees contain directors with a variety of relevant skills and experience so that no undue reliance is placed on any one individual.

The non-executive directors combine broad business and commercial experience with independent and objective judgement. The balance between non-executive and executive directors enables the Board to provide clear and effective leadership and maintain the highest standards of integrity across the company's business activities. The names and biographies of all Board members are set out on page 61.

The composition of the Board is subject to continuing review and the provisions of the Code will be taken into account in respect of the balance of the Board. The Code requires the Board to determine whether its non-executive members are independent.

Following the annual general meeting in April 2005 when Sir Angus Grossart, Lord Vallance and Iain Robertson will stand down from the Board, the Board will comprise eight independent and five non-independent directors (including executive directors), in addition to the Chairman. Bob Scott has been nominated as the senior independent director.

The Board considers that all non-executive directors are independent for the purposes of the Code, with the following exceptions:

- Sir Angus Grossart and Lord Vallance, who have served on the Board for 19 and 12 years, respectively.
- Iain Robertson who was formerly an executive director of the company.
- Bud Koch who was formerly Chairman, President and Chief Executive Officer of Charter One Financial, Inc. which was acquired by Citizens Financial Group, Inc.

As a result, in terms of the Code, the Board currently comprises eight independent and eight non-independent directors (including executive directors), in addition to the Chairman.

*Re-election of directors*

At each annual general meeting, one third of the directors retire and offer themselves for re-election and each director must stand for re-election at least once every three years. Any non-executive directors who have served for more than nine years will also stand for annual re-election and the Board may consider their independence at that time. The proposed reelection of directors is subject to prior review by the Board.

The names of directors standing for re-election at the 2005 annual general meeting are contained on page 63 and further information will be given in the Chairman's letter to shareholders in relation to the company's annual general meeting.

*Information, induction and professional development*

All directors receive accurate, timely and clear information on all relevant matters. Any requests for further information or clarification are dealt with or co-ordinated by the Group Secretary.

The Group Secretary is responsible for advising the Board, through the Chairman, on all governance matters. All directors have access to the advice and services of the Group Secretary who is responsible to the Board for ensuring that Board procedures are followed and that applicable rules and regulations are complied with. In addition, all directors are able, if necessary, to obtain independent professional advice at the company's expense.

Each new director receives a formal induction, including visits to all the Group's major businesses and meetings with senior management. The induction is tailored to the director's specific requirements. Existing directors undertake such professional development as they consider necessary in assisting them to carry out their duties as directors.

*Performance evaluation*

The annual performance evaluation of the Board and its Committees was undertaken in the autumn of 2004. The evaluation, which focused particularly on the Board Committees, was conducted by the Group Secretary using a detailed questionnaire and meetings with each of the Board Committee members and attendees to discuss the performance of the Committees.

In addition, each director discussed his or her own performance with the Chairman and the senior independent director met individually with the executive directors and with the non-executive directors as a group without the Chairman present, to consider the Chairman's performance. The report on the Board evaluation, which was designed to assist the Board in further improving its performance, was considered and discussed by the Board as a whole and specific actions are currently being implemented. A performance evaluation is conducted on an annual basis.

*Board Committees*

In order to provide effective oversight and leadership, the Board has established a number of Board Committees with particular responsibilities. The Committee chairmanship and membership are reviewed on a regular basis. The names and biographies of all Board Committee members are set out on page 61.

*Audit Committee*

All members of the Audit Committee are independent non-executive directors. The Audit Committee has five meetings each year, two of which are held immediately prior to submission of the interim and year-end financial statements to the Group Board. The Audit Committee meets executive directors and management and the external and internal auditors privately.

The Board is satisfied that the Audit Committee members have recent and relevant financial experience. Although the Board has determined that each member of the Audit Committee is an "Audit Committee Financial Expert" as defined in the SEC rules under the US Securities Exchange Act of 1934, the members of the Audit Committee are selected with a view to the expertise and experience of the Audit Committee as a whole, and the Audit Committee reports to the Board as a single entity. The designation of a director or directors as an "Audit Committee Financial Expert" does not impose on any such director any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such director as a member of the Audit Committee and Board in the absence of such a designation. Nor does the designation of a director as an "Audit Committee Financial Expert" affect the duties, obligations or liability of any other member of the Board.

The Audit Committee is responsible for assisting the Board in discharging its responsibilities and making all relevant disclosures in relation to the financial affairs of the Group, the arrangements for accounting and financial reporting and regulatory compliance, the standards of internal control, and arrangements for internal audit, risk management and the external auditors.

The Audit Committee has a policy on the engagement of the external auditors to supply audit and non-audit services, which takes into account relevant legislation regarding the provision of such services by an external audit firm. Details of the audit and non-audit services carried out by the external auditors are set out in Note 4 to the Group's accounts. This policy is reviewed annually by the Audit Committee. In addition, the Audit Committee reviews and monitors the independence and objectivity of the external auditors when it approves non-audit work to be carried out by them, taking into consideration relevant legislation and ethical guidance. A detailed submission is also made by management to the Audit Committee prior to certain appointments. The submission contains, in particular, details as to why the proposed appointment would not breach auditor independence.

The Audit Committee also undertakes an annual evaluation to assess the independence and objectivity of the external auditors and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements. The results of the evaluation were reported to the Board.

The Audit Committee will make recommendations to the Board in relation to the remuneration and terms of engagement of the external auditors and the re-appointment by the shareholders at the annual general meeting in April 2005 of Deloitte & Touche LLP as the external auditors.

In 2004, the Audit Committee commissioned KPMG to conduct an external review of the effectiveness of Group Internal Audit. It is intended that there will be an external review of Group Internal Audit every three years with internal reviews continuing in the intervening years.



## **Corporate governance** continued

*Remuneration Committee*

All members of the Remuneration Committee are independent non-executive directors. The Remuneration Committee has three meetings each year.

The Remuneration Committee is responsible for assisting the Board in discharging its responsibilities and making all relevant disclosures in relation to the formulation and review of the Group's executive remuneration policy. The Remuneration Committee makes recommendations to the Board on the remuneration arrangements for its executive directors and the Chairman. The Directors' Remuneration Report is contained on pages 70 to 79.

Responsibility for determining the remuneration of executive directors has not been delegated to the Remuneration Committee, and in that sense the provisions of the Code have not been complied with. The Board as a whole reserves the authority to make the final determination of the remuneration of directors as it considers that this two stage process allows greater consideration and evaluation and is consistent with the unitary nature of the Board. No director is involved in decisions regarding his or her own remuneration.

*Nominations Committee*

The Nominations Committee comprises independent non-executive directors, under the chairmanship of the Chairman of the Board. The Nomination Committee meets as required.

The Nominations Committee is responsible for assisting the Board in the formal selection and appointment of directors. It considers potential candidates and recommends appointments of new directors to the Board. The appointments are based on merit and against objective criteria including the time available, and commitment which will be required of, the potential director.

In addition, the Nominations Committee considers succession planning for the Chairman, Group Chief Executive and non-executive directors. The Nominations Committee takes into account the knowledge, mix of skills, experience and networks of contacts which will be needed on the Board in the future. The Chairman, Group Chief Executive and non-executive directors meet to consider executive succession planning. No director is involved in decisions regarding his or her own succession.

The Board is aware of the other commitments of its directors and is satisfied that these do not conflict with their duties as non-executive directors of the company.

*Meetings*

The number of meetings of the Board and the Audit, Remuneration and Nominations Committees and individual attendance by members is shown below.

| | Board | Audit | Remuneration | Nominations |
|---|---|---|---|---|
| Total number of meetings in 2004 | 10 | 5 | 4 | 1 |
| Number of meetings attended in 2004 | | | | |
| Sir George Mathewson | 10 | – | – | 1 |
| Lord Vallance | 10 | – | – | – |
| Sir Angus Grossart | 9 | – | – | – |
| Sir Fred Goodwin | 10 | – | – | – |
| Mr Botin*** | 3 | – | – | – |
| Mr Buchan | 10 | 5 | 4 | – |
| Dr Currie | 10 | – | 4 | – |
| Mr Fish | 7 | – | – | – |
| Mr Hunter* | 4 | 1 | – | – |
| Mr Inciarte*** | 5 | – | – | – |
| Mr Koch* | 4 | – | – | – |
| Mr MacHale* | 4 | 1 | – | – |
| Miss Mackay | 10 | 5 | 4 | – |
| Mr McLuskie** | 6 | – | – | – |
| Mr Pell | 9 | – | – | – |
| Mr Robertson | 10 | – | – | – |
| Sir Steve Robson | 10 | 4 | – | – |
| Mr Scott | 10 | – | 4 | 1 |

| | | | | |
|---|---|---|---|---|
| Mr Sutherland | 10 | – | – | 1 |
| Mr Watt | 10 | – | – | – |

* Mr Hunter and Mr MacHale were appointed to the Board and the Audit Committee on 1 September 2004. Mr Koch was appointed to the Board on 29 September 2004.
** Mr McLuskie retired from the Board on 23 August 2004.
*** Mr Botin and Mr Inciarte resigned from the Board on 12 November 2004, the effective date of the acquisition of Abbey National plc by Banco Santander Central Hispano SA. They did not attend any Board meetings from June 2004 during the relevant public offer period.



*Relations with shareholders*

The company communicates with shareholders through the annual report and by providing information in advance of the annual general meeting. Individual shareholders can raise matters relating to their shareholdings and the business of the Group at any time throughout the year. Shareholders are given the opportunity to ask questions at the annual general meeting or submit written questions in advance. The chairmen of the Audit, Remuneration and Nominations Committees are available to answer questions at the annual general meeting.

Communication with the company’s largest institutional shareholders is undertaken as part of the company’s investor relations programme. During the year, the directors received copies of the analysts’ reports and a monthly report from the Group’s investor relations team which includes an analysis of share price movements, the Group’s performance against the sector, and key broker comments. In addition, information on major investor relations activities and changes to external ratings are provided. In 2004, the senior independent director attended the analysts’ presentation at the interim results to enhance his understanding of the issues and concerns of the major shareholders and would be available to shareholders if concerns could not be addressed through the normal channels. The mechanisms used to ensure that directors develop an understanding of the views of major shareholders are considered as part of the annual Board performance evaluation.

The Chairman, Group Chief Executive, Group Finance Director and, if appropriate, the senior independent director communicate shareholder views to the Board as a whole.

The terms of reference of the Audit, Remuneration and Nominations Committees and the standard terms and conditions of the appointment of non-executive directors are available on the Group’s website (www.rbs.com) and copies are available on request.

*Internal control*

The Board of directors is responsible for the Group’s system of internal control that is designed to facilitate effective and efficient operations and to ensure the quality of internal and external reporting and compliance with applicable laws and regulations. In devising internal controls, the Group has regard to the nature and extent of the risk, the likelihood of it crystallising and the cost of controls. A system of internal control is designed to manage, but not eliminate, the risk of failure to achieve business objectives and can only provide reasonable, and not absolute, assurance against the risk of material misstatement, fraud or losses.

The Board has established a process for the identification, evaluation and management of the significant risks faced by the Group, which operated throughout the year ended 31 December 2004 and to 23 February 2005, the date the directors approved the Report and Accounts. This process is regularly reviewed by the Board and meets the requirements of the guidance “Internal Control: Guidance for Directors on the Combined Code” issued by the Institute of Chartered Accountants in England and Wales in 1999.

The effectiveness of the Group's internal control system is reviewed regularly by the Board and the Audit Committee. Executive management committees or boards of directors in each of the Group's businesses receive quarterly reports on significant risks facing their business and how they are being controlled. These reports are combined and submitted to the Board as quarterly risk and control assessments. Additional details of the Group's approach to risk management are given in the 'Risk management' section of the 'Operating and financial review' on pages 42 to 58. The Audit Committee also receives regular reports from Group Risk Management and Group Internal Audit. In addition, the Group's independent auditors present to the Audit Committee reports that include details of any significant internal control matters which they have identified. The system of internal controls of the authorised institutions and other regulated entities in the Group are also subject to regulatory oversight in the UK and overseas. Additional details of the Group's regulatory oversight are given in the Supervision and Regulation section.

*Disclosure controls and procedures*

As required by US regulations, the Group Chief Executive and the Group Finance Director have evaluated the effectiveness of the company's disclosure controls and procedures (as defined in the rules under the US Securities Exchange Act). This evaluation has been considered and approved by the Board which has authorised the Group Chief Executive and the Group Finance Director to certify that as at 31 December 2004, the company's disclosure controls and procedures were adequate and effective and designed to ensure that material information relating to the company and its consolidated subsidiaries would be made known to them by others within those entities.

*Changes in internal controls*

There was no change in the company's internal control over financial reporting that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



---

## Directors' remuneration report

*The Remuneration Committee*

The following directors, all of whom are independent non-executive directors, were members of the Remuneration Committee during the year ended 31 December 2004.

Bob Scott (Chairman)
Colin Buchan
Jim Currie
Eileen Mackay

During the accounting period, the Remuneration Committee confirmed the appointments of Ernst & Young and Mercer Human Resource Consulting to provide advice on matters relating to directors' remuneration in the UK and US respectively. In addition, the Remuneration Committee has taken account of the views of the Chairman and the Group Chief Executive on performance assessment of the executive directors.

In addition to advising the Remuneration Committee, Ernst & Young provided professional services in the ordinary course of business including actuarial and corporate recovery advice. Mercer Human Resource Consulting provided advice and support in connection with a range of benefits, pension actuarial and investment matters.

*Remuneration policy*

The executive remuneration policy is kept under review by the Remuneration Committee and is set out below. There have been no material changes to the policy which was approved by shareholders at the company's annual general meeting in 2004.

The objective of the executive remuneration policy is to provide, in the context of the company's business strategy, remuneration in form and amount which will attract, motivate and retain high calibre executives. In order to achieve this objective, the policy is framed around the following core principles:

- Total rewards will be set at levels that are competitive within the relevant market, taking each executive director's remuneration package as a whole.
- Total potential rewards will be earned through achievement of demanding performance targets based on measures consistent with shareholder interests over the short, medium and longer-term.
- Remuneration arrangements will strike an appropriate balance between fixed and performance related rewards. Performance related elements will comprise the major part of executive remuneration packages.
- Incentive plans and performance metrics will be structured to be robust through the business cycle.
- Remuneration arrangements will be designed to support the company's business strategy, to promote appropriate teamwork and to conform to best practice standards.

The non-executive directors' fees are reviewed annually by the Board, on the recommendation of the Chairman. The level of remuneration reflects the responsibility and time commitment of directors and the level of fees paid to non-executive directors of comparable major UK companies. Non-executive directors do not participate in any incentive or performance plan.

The Remuneration Committee approves the remuneration arrangements of senior executives below Board level who are members of the Group Executive Management Committee, on the recommendation of the Group Chief Executive, and reviews all long-term incentive arrangements which are operated by the Group.

*Components of executive remuneration*
*UK based directors*
*Salary*

Salaries are reviewed annually as part of total remuneration, having regard to remuneration packages received by executives of comparable companies. The Remuneration Committee uses a range of survey data from remuneration consultants and reaches individual salary decisions taking account of the remuneration environment and the performance and responsibilities of the individual director.

*Benefits*

UK-based executive directors are eligible to participate in The Royal Bank of Scotland Group Pension Fund ("the RBS Fund"). The RBS Fund is a non-contributory defined benefit fund which provides pensions and other benefits within Inland Revenue limits. Certain directors receive additional pension and life assurance benefits in excess of Inland Revenue limits. Details of pension arrangements of directors are shown on page 79.

Executives directors are eligible to receive a choice of various employee benefits or a cash equivalent, on a similar basis to other employees. In addition, like other employees, executive directors are eligible also to participate in Sharesave, Buy As You Earn and the Group profit sharing scheme, which currently pays up to 10 per cent of salaries, depending on the Group's performance. These schemes are not subject to performance conditions since they are operated on an all-employee basis. Executive directors also receive death in service benefits.

*Short-term annual incentives*

These typically focus from year to year on the delivery of a combination of appropriate Group and individual financial and operational targets approved by the Remuneration Committee. Individual UK-based executive directors normally have a maximum annual bonus potential of one times salary (one and a half times in the case of the Group Chief Executive), although for exceptional performance, as measured by the achievement of significant objectives, bonuses of up to two times salary may be awarded.

*Long-term incentives*

The company provides long-term incentives in the form of share options and share or share equivalent awards. Their objective is to encourage the creation of value over the long-term and to align the rewards of the executive directors with the returns to shareholders. Directors are encouraged to hold shares in the company and a culture of voluntary shareholding has been fostered, which has resulted in a number of executive directors building up substantial shareholdings over time.

*Medium-term performance plan*

The medium-term performance plan was approved by shareholders in April 2001. Each executive director is eligible for an annual award under the plan in the form of share or share equivalent awards. Whilst the rules of the plan allow grants of awards of up to one and a half times earnings, the Remuneration Committee has adopted a policy of granting awards based on a multiple of salary. Normally awards are made at one times salary with one and a half times salary being granted in the case of the Group Chief Executive. No changes will be made to this policy without prior consultation with shareholders.

The plan is highly geared to the company's relative performance. All awards under the plan are subject to three-year performance targets. First, the annual growth in the company's earnings per share ("EPS") must exceed the annualised growth of the Retail Prices Index ("RPI") plus three per cent. If this condition is satisfied, the company's total shareholder return ("TSR") is compared with the TSR of a comparator group of certain companies in the financial services sector, referred to below. Awards under the plan will not vest if the company's TSR is below the median of the comparator group. Achievement of the EPS target and median TSR performance against the comparator companies will result in vesting of 25 per cent of the award, increasing on a sliding scale up to 100 per cent at upper quartile performance and up to 200 per cent at upper decile performance. Vesting at 200 per cent can only occur if the company achieves a TSR ranking at 1st position in the comparator group and exceeds the TSR of the 2nd placed comparator company by at least 34%.This combination of EPS and TSR performance targets measures the underlying financial performance of the company and ensures a direct link between the value delivered to shareholders and the levels of incentive payment.

For awards made since 2002, the companies in the comparator group are Abbey National plc; Aviva plc; Barclays PLC; Citigroup; HBOS plc; HSBC Holdings plc; Legal & General Group plc; Lloyds TSB Group plc; Prudential plc and Standard Chartered PLC. Following the takeover of Abbey National plc by Banco Santander Central Hispano SA ("BSCH") in November 2004, Abbey National plc has been replaced by BSCH in the comparator group for awards made from 2003 onwards.

*Options*

The executive share option scheme was approved by shareholders in January 1999. Each executive director is eligible for the annual grant of an option, typically of one and a quarter times salary with an upper maximum in appropriate circumstances of two and a half times salary, over shares at the market value at date of grant. Under the terms of his appointment, the Chairman is also eligible to participate in the executive share option scheme. No payment is made by the executive director on the grant of an option award.

All executive share options are subject to a performance target, which is currently that the options are exercisable only if, over a three year period, the growth in the company's EPS has exceeded the growth in the RPI plus nine per cent. This EPS performance target, which is consistent with market practice, measures underlying financial performance and represents a long-term test of performance. For awards made in 2004 onwards, there is no re-testing of the performance condition. The condition is reviewed annually. All previous awards have vested without re-testing.



---

## **Directors remuneration report** continued

*US based director  Lawrence Fish*

Lawrence Fish's total remuneration package was reviewed in 2004 by the Remuneration Committee as a result of the acquisition of Charter One and his changing RBS responsibilities in North America. In the review the Remuneration Committee confirmed its overall policy in relation to his package is to ensure competitiveness with the market levels of total remuneration for chairmen and executives of US banks of similar size and complexity.

As a result of that review, proposals will be submitted at the annual general meeting to introduce a cash long term incentive plan, which will replace the Citizens Phantom 2000 Plan in which Mr Fish participated from 2001. Subject to agreement to these proposals, the total remuneration policy for him will be as follows:

*Base salary* will be set having regard to the levels of base salary in other US banks and the appropriate balance of fixed and variable remuneration for US based executives of UK listed companies operating within the corporate governance frameworks of the UK. In light of this policy, and having reviewed the relevant market data, Mr Fishs base salary was increased to $1.5 million with effect from 1 October 2004.

*Benefits* Mr Fish accrues pension benefits under a number of arrangements in the US. Details are provided on page 79. In addition he is entitled to receive other benefits on a similar basis to other Citizens employees.

*Short term performance rewards* will take the form of an annual incentive plan which rewards the achievement of Group, business unit and individual financial and non-financial targets. The normal maximum annual bonus potential will be two times salary, although additional amounts to a maximum of two times salary may be awarded, at the discretion of the Board, for exceptional performance as measured by the achievement of significant objectives.

*Long term incentives* will consist of the following components:

- The two grants made under the Citizens Phantom 2000 Plan vested and will vest on 1 January 2005 and 1 January 2006, respectively. The value of units at the time of vesting is performance-linked and is based on the cumulative economic profit generated by Citizens, the trend in economic profit and on the external market trends in the US banking sector, using price/earnings ratios of comparator US banks. This measure was chosen to establish a clear link between the potential incentive and the performance of Citizens. No other grants will be made under this plan.
- A grant under the RBS medium-term performance plan within the levels, and on the same terms, available to UK based executives.
- A grant under the executive share option scheme within the levels, and on the same terms, available to UK based executives.
- A grant under the new Citizens Long Term Incentive Plan. Performance will be measured on a combination of Growth in Profit before Tax and Relative Return on Equity based on a comparison of Citizens with comparator US banks. The targets for this plan will be set on an annual basis over the three year term of the grant.

In the event that the proposed new Citizens Long Term Incentive Plan is not approved, Mr Fish will participate in existing approved short and long term cash plans already operating in Citizens.

The existing approved Citizens Long Term Incentive Plan is a cash compensation plan designed to reward participants for achieving long-term financial results. A separate three-year cycle commences each year. The maximum award payable to Mr Fish annually is 105 per cent of his average salary over the previous three-year period. Each three-year performance target is based on the annual pre-tax income target for Citizens. For the maximum award to be paid in respect of each three-year target, Citizens must achieve 130 per cent of the three-year aggregate budgeted profit figure. This performance target is measured by taking the pre-tax income for Citizens, which is a simple and transparent method of measuring a profit figure target.



---

*The performance graph*

The undernoted performance graph illustrates the performance of the company over the past five years in terms of total shareholder return compared with that of the companies comprising the FTSE 100 index. This index has been selected because it represents a cross-section of leading UK companies. The total shareholder return for the company and the FTSE 100 have been rebased to 100 for 1999.

Total shareholder return

*Service contracts*

The company's policy in relation to the duration of contracts with directors is that executive directors' contracts generally continue until termination by either party, subject to the required notice, or until retirement date. The notice period under the service contracts of executive directors will not normally exceed 12 months. However, the notice period may exceed 12 months if existing service contracts have notice periods greater than 12 months and the Remuneration Committee considers it appropriate not to reduce the existing notice period. In relation to newly recruited executive directors, subject to the prior approval of the Remuneration Committee, the notice period from the employing company required to terminate the contract will not normally exceed 12 months unless there is a clear case for this. Where a longer period of notice is initially approved on appointment, it will normally be structured such that it will automatically reduce to 12 months in due course.

All new service contracts for executive directors will be subject to approval by the Remuneration Committee. It will be the norm to include in those contracts standard clauses covering the performance review process, the company's normal disciplinary procedure, and terms for dismissal in the event of failure to perform or in situations involving actions in breach of the Group's policies.

Any compensation payment made in connection with the departure of an executive director will be subject to approval by the Remuneration Committee, having regard to the terms of the service contract and the reasons for termination.



---

Information regarding executive directors service contracts is summarised in the table and notes below.

| Name | Date of current contract/ Employing company | Normal retirement age | Notice period from company | Notice period from executive |
|---|---|---|---|---|
| Sir Fred Goodwin | 1 August 1998 The Royal Bank of Scotland plc | 60 | 12 months | 6 months |
| Mr McLuskie* | 9 October 1997 The Royal Bank of Scotland plc | 60 | 3 months | 3 months |
| Mr Pell | 22 May 2002 National Westminster Bank Plc | 60 | 12 months | 6 months |
| Mr Watt | 28 September 2000 The Royal Bank of Scotland plc | 60 | 12 months | 6 months |
| Mr Fish | 18 February 2004 Citizens Financial Group, Inc. | 65 | 12 months | 12 months |

* retired 23 August 2004

Except as noted below, in the event of severance of contract where any contractual notice period is not worked, the employing company may pay a sum to the executive in lieu of this period of notice. Any such payment would, at maximum, comprise base salary and a cash value in respect of fixed benefits (including pension plan contributions). In the event of situations involving breach of the employing companys policies resulting in dismissal, reduced or no payments may be made to the executive. Depending on the circumstances of the termination of employment, the executive may be entitled, or the Remuneration Committee may exercise its discretion to allow, the executive to exercise outstanding awards under long-term incentive arrangements. Exceptions to these severance arrangements are as follows:

- Gordon Pell was recruited to the board of NatWest from Lloyds Bank plc at a time when NatWest was subject to a contested takeover. His recruitment to take management responsibility for NatWests retail operations was seen by the NatWest board at the time as an essential step to strengthen the management of NatWest. The terms of his service contract, which reflected these circumstances, were entered into after consultation with the Takeover Panel as required by The City Code on Takeovers and Mergers. If Mr Pells contract is terminated by NatWest without notice, he is entitled to a compensation payment of base salary relating to the contractual 12 months notice period, his annual bonus to the date of termination, a payment equal to his average annual bonus over the previous three years, payment in lieu of contractual benefits and allowances including pension and extra payments by way of funded or unfunded pension and death in service contributions relating to the notice period.

  The Remuneration Committee has reviewed, with the benefit of legal advice, Mr Pells contract, and the circumstances under which it was entered into. As the exceptional severance provisions would apply only if NatWest were to breach the contract by terminating it without notice, the Committee considers that the contracts terms, entered into in good faith by the NatWest board and Mr Pell, should be honoured.

- If Lawrence Fish's contract is terminated without cause, or if he terminates the contract for good reason (as defined in the contract), he is entitled to a lump sum payment to compensate him for the loss of 12 months salary plus annual bonus. Mr Fish would also be entitled to receive for this period health, life insurance and long term disability coverage and any other benefits determined in accordance with the plans, policies and practices of Citizens at the time of termination. The Remuneration Committee have been advised that these termination provisions are less generous than the current market practice in the US.



*Chairman and non-executive directors*

The original date of appointment as a director of the company and the scheduled date for the next re-election is as follows:

| | Date first appointed | Next re-election |
|---|---|---|
| Sir George Mathewson | 1 September 1987 | 2007 |
| Lord Vallance | 14 January 1993 | Retires 20 April 2005 |
| Sir Angus Grossart | 30 September 1985 | Retires 20 April 2005 |
| Mr Buchan | 1 June 2002 | 2006 |
| Dr Currie | 28 November 2001 | 20 April 2005 |
| Mr Hunter | 1 September 2004 | 20 April 2005 |
| Mr Koch | 29 September 2004 | 20 April 2005 |
| Mr MacHale | 1 September 2004 | 20 April 2005 |
| Miss Mackay | 16 May 1996 | 2006 |
| Mr Robertson | 14 January 1993 | Retires 20 April 2005 |
| Sir Steve Robson | 25 July 2001 | 20 April 2005 |
| Mr Scott | 31 January 2001 | 2006 |
| Mr Sutherland | 31 January 2001 | 2006 |

Other than Iain Robertson, the non-executive directors do not have service contracts or notice periods although they have letters of engagement reflecting their responsibilities and commitments. Under the company's articles of association, all directors must retire by rotation and seek re-election by shareholders at least every three years. No compensation would be paid to the Chairman or to any non-executive director in the event of early termination.

Iain Robertson entered into a contract to reflect his role as a non-executive director, which took effect on 25 June 2003. Under this contract, his appointment will terminate at the company's annual general meeting on 20 April 2005, unless terminated earlier by either party on one month's written notice.

The tables and explanatory notes on pages 76 to 79 report the remuneration of each director for the year ended 31 December 2004 and have been audited by the company's auditors, Deloitte & Touche LLP.

## **Directors’ remuneration report** continued

*Directors’ remuneration*

| | Salary/ fees £000 | Performance bonus* £000 | Benefits £000 | 2004 Total £000 | 2003 Total £000 |
|---|---|---|---|---|---|
| Chairman | | | | | |
| Sir George Mathewson | 542 | — | 39 | 581 | 538 |
| Executive directors | | | | | |
| Sir Fred Goodwin | 990 | 1,500 | 32 | 2,522 | 1,916 |
| Mr Fish | 637 | 1,638 | 30 | 2,305 | 1,859 |
| Mr McLuskie (retired 23 August 2004) | 341 | — | 1 | 342 | 1,048 |
| Mr Pell | 670 | 721 | 12 | 1,403 | 1,307 |
| Mr Watt | 605 | 660 | 3 | 1,268 | 1,110 |

* includes 10% profit sharing

Basic salary is the only component of the remuneration package which is pensionable.

| Non-executive directors | Board fees £000 | Board committee fees £000 | 2004 Total £000 | 2003 Total £000 |
|---|---|---|---|---|
| Vice-chairmen | | | | |
| Lord Vallance of Tummel | 100 | — | 100 | 100 |
| Sir Angus Grossart | 100 | — | 100 | 100 |
| Mr Botin (resigned 12 November 2004) | 46 | — | 46 | 44 |
| Mr Buchan | 50 | 50 | 100 | 56 |
| Dr Currie | 50 | 10 | 60 | 54 |
| Mr Hunter (appointed 1 September 2004) | 17 | 5 | 22 | — |
| Mr Inciarte (resigned 12 November 2004) | 46 | — | 46 | 44 |
| Mr Koch† (appointed 29 September 2004) | 12 | — | 12 | — |
| Mr MacHale (appointed 1 September 2004) | 17 | 5 | 22 | — |
| Miss Mackay | 50 | 25 | 75 | 64 |
| Mr Robertson | 100 | — | 100 | 217* |
| Sir Steve Robson | 50 | 15 | 65 | 54 |
| Mr Scott | 50 | 23 | 73 | 67 |
| Mr Sutherland | 50 | 3 | 53 | 44 |

* includes £167,000 in respect of Mr Robertson’s service as an executive director. From 25 June 2003, Mr Robertson has carried out his role as Chairman, Corporate Banking and Financial Markets and as a director in a non-executive capacity. He also provides general advice on business issues to the Board and Board Committees as appropriate, including attendance as required at the Group Audit Committee and the Advances Committee. For these services Mr Robertson receives a fee of £100,000 per annum.

† In addition to his role as a non-executive director, Mr Koch has an agreement with Citizens Financial Group, Inc. to provide consulting services for a period of three years following the acquisition by Citizens of Charter One Financial, Inc. For these services Mr Koch receives $402,500 per annum.

No director received any expense allowances chargeable to UK income tax or compensation for loss of office/termination payment. The non-executive directors did not receive any bonus payments or benefits.

*Share options*

Options to subscribe for ordinary shares of 25p each in the company granted to, and exercised by, directors during the year to 31 December 2004 are included in the table below:

| | | | Options exercised in 2004 | | | Options held at 31 December 2004 | |
|---|---|---|---|---|---|---|---|
| | Options held at 1 January 2004 | Options granted in 2004 | Number | Market price at date of exercise £ | Option price £ | Number | Exercise period |
| Sir George Mathewson | 69,257 | | | | 9.33 | 69,257 | 11.05.01 – 10.05.08 |
| | 147,247 | | | | 7.81 | 147,247 | 29.03.03 – 28.03.10 |
| | 150 | | | | 12.40 | 150 | 09.08.03 – 08.08.06* |
| | 20,100 | | | | 17.18 | 20,100 | 14.08.04 – 13.08.11 |
| | 1,347 | | | | 13.64 | 1,347 | 01.10.08 – 31.03.09* |
| | 19,500 | | | | 18.18 | 19,500 | 14.03.05 – 13.03.12 |
| | 36,400 | | | | 12.37 | 36,400 | 13.03.06 – 12.03.13 |
| | | 36,044 | | | 17.34 | 36,044 | 11.03.07 – 10.03.14 |
| | 294,001 | 36,044 | | | | 330,045 | |
| Sir Fred Goodwin | 164,571 | | | | 8.75 | 164,571 | 07.12.01 – 06.12.08 |
| | 2,963 | | | | 11.18 | 2,963 | 04.03.02 – 03.03.09 |
| | 27,306 | | | | 11.97 | 27,306 | 03.06.02 – 02.06.09 |
| | 153,648 | | | | 7.81 | 153,648 | 29.03.03 – 28.03.10 |
| | 150 | | 150 | 16.20 | 12.40 | – | |
| | 43,700 | | | | 17.18 | 43,700 | 14.08.04 – 13.08.11 |
| | 1,713 | | | | 9.85 | 1,713 | 01.10.05 – 31.03.06* |
| | 41,300 | | | | 18.18 | 41,300 | 14.03.05 – 13.03.12 |
| | 72,800 | | | | 12.37 | 72,800 | 13.03.06 – 12.03.13 |
| | | 144,175 | | | 17.34 | 144,175 | 11.03.07 – 10.03.14 |
| | 508,151 | 144,175 | 150 | | | 652,176 | |
| Mr Fish | 107,877 | | | | 9.33 | 107,877 | 11.05.01 – 10.05.08 |
| | 150 | | | | 12.40 | 150 | 09.08.03 – 08.08.06* |
| | 108,027 | | | | | 108,027 | |
| Mr McLuskie** | 16,613 | | | | 9.33 | 16,613 | 11.05.01 – 10.05.08 |
| | 8,860 | | | | 11.18 | 8,860 | 04.03.02 – 03.03.09 |
| | 11,356 | | | | 11.97 | 11,356 | 03.06.02 – 02.06.09 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | 33,291 | | | | 7.81 | 33,291 | 29.03.03 – 28.03.10 |
| | 150 | | | | 12.40 | 150 | 09.08.03 – 08.08.06* |
| | 23,300 | | | | 17.18 | 23,300 | 14.08.04 – 13.08.11 |
| | 335 | | | | 13.64 | 335 | 01.10.04 – 31.03.05* |
| | 22,100 | | | | 18.18 | 22,100 | 14.03.05 – 13.03.12 |
| | 335 | | | | 12.35 | 335 | 01.10.05 – 31.03.06* |
| | 39,700 | | | | 12.37 | 39,700 | 13.03.06 – 12.03.13 |
| | 156,040 | | | | | 156,040 | |
| Mr Pell | 51,216 | | | | 7.81 | 51,216 | 29.03.03 – 28.03.10 |
| | 29,100 | | | | 17.18 | 29,100 | 14.08.04 – 13.08.11 |
| | 27,600 | | | | 18.18 | 27,600 | 14.03.05 – 13.03.12 |
| | 49,800 | | | | 12.37 | 49,800 | 13.03.06 – 12.03.13 |
| | | 47,217 | | | 17.34 | 47,217 | 11.03.07 – 10.03.14 |
| | 157,716 | 47,217 | | | | 204,933 | |
| Mr Robertson | 56,635 | | | | 9.33 | 56,635 | 11.05.01 – 10.05.08 |
| | 82,654 | | | | 11.18 | 82,654 | 04.03.02 – 03.03.09 |
| | 128,040 | | | | 7.81 | 128,040 | 29.03.03 – 28.03.10 |
| | 393 | | 393 | 16.77 | 9.85 | – | |
| | 36,400 | | | | 17.18 | 36,400 | 14.08.04 – 13.08.11 |
| | 304,122 | | 393 | | | 303,729 | |
| Mr Watt | 70,148 | | | | 12.83 | 70,148 | 04.09.03 – 03.09.10 |
| | 23,300 | | | | 17.18 | 23,300 | 14.08.04 – 13.08.11 |
| | 710 | | 710 | 16.21 | 13.64 | – | |
| | 22,100 | | | | 18.18 | 22,100 | 14.03.05 – 13.03.12 |
| | 42,500 | | | | 12.37 | 42,500 | 13.03.06 – 12.03.13 |
| | | 43,253 | | | 17.34 | 43,253 | 11.03.07 – 10.03.14 |
| | 158,758 | 43,253 | 710 | | | 201,301 | |

* Options held under the sharesave and option 2000 schemes, which are not subject to performance conditions.

** Mr McLuskie retired from the Group Board on 23 August 2004. The figures quoted above are as at cessation. Subsequently, Mr McLuskie exercised his Sharesave 2001 grant of 335 options, and has since been granted a Sharesave award in 2004 of 439 options.

**Directors’ remuneration report** continued

No options had their terms and conditions varied during the accounting period to 31 December 2004. No payment is required on the award of an option.

The executive share options which are exercisable from March 2002 onwards are subject to the satisfaction of an EPS growth target which provides that options are excercisable only if, over a three year period, the growth in the company’s EPS has exceeded the growth in the RPI plus 9%. In respect of executive share options exercisable before March 2002 the performance condition is that the growth in the company’s EPS over three years has exceeded the growth in the RPI plus 6%.

The market price of the company’s ordinary shares at 31 December 2004 was £17.52 and the range during the year to 31 December 2004 was £14.64 to £17.64.

In the ten year period to 31 December 2004, awards made using new issue shares under the company’s share plans represented 4.3% of the company’s issued ordinary share capital, leaving an available dilution headroom of 5.7%.

*Medium Term Performance Plan*

| | Scheme interests (share equivalents) at 1 January 2004 | Awards granted in 2004 | Market price on award £ | Awards vested in 2004* | Market price on vesting £ | Value of interests vested £ | Awards exercised in 2004 | Market price on exercise £ | Share interest (share equivalents) at 31 December 2004 | End of period for qualifying conditions to be fulfilled |
|---|---|---|---|---|---|---|---|---|---|---|
| Sir Fred Goodwin | 93,040 | | 16.35 | | | | | | 93,040 | vested 31.12.03 |
| | 44,378 | | 18.59 | 33,855 | 17.52 | 593,140 | | | 33,855 | vested 31.12.04 |
| | 78,398 | | 17.22 | | | | | | 78,398 | 31.12.05 |
| | | 86,506 | 17.34 | | | | | | 86,506 | 31.12.06 |
| | 215,816 | | | | | | | | 291,799 | |
| Mr Fish | – | 35,274 | 17.34 | | | | | | 35,274 | 31.12.06 |
| Mr McLuskie** | 49,621 | | 16.35 | | | | 49,621 | 16.49 | – | vested 31.12.03 |
| | 23,399 | | 18.59 | 17,851 | 17.52 | 312,750 | | | 17,851 | vested 31.12.04 |
| | 28,456 | | 17.22 | | | | | | 28,456 | 31.12.05 |
| | 101,476 | | | | | | | | 46,307 | |
| Mr Pell | 62,026 | | 16.35 | | | | 40,000 | 17.12 | 22,026 | vested 31.12.03 |
| | 29,585 | | 18.59 | 22,570 | 17.52 | 395,426 | | | 22,570 | vested 31.12.04 |
| | 35,715 | | 17.22 | | | | | | 35,715 | 31.12.05 |
| | | 37,774 | 17.34 | | | | | | 37,774 | 31.12.06 |
| | 127,326 | | | | | | | | 118,085 | |
| Mr Robertson | 77,533 | | 16.35 | | | | | | 77,533 | vested 31.12.03 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | vested |
| Mr Watt | 49,621 | | 16.35 | | | | 49,621 | 14.71 | – | 31.12.03 vested |
| | 24,744 | | 18.59 | 18,877 | 17.52 | 330,725 | | | 18,877 | 31.12.04 |
| | 30,488 | | 17.22 | | | | | | 30,488 | 31.12.05 |
| | | 34,603 | 17.34 | | | | | | 34,603 | 31.12.06 |
| | 104,853 | | | | | | | | 83,968 | |

* Awards were granted on 11 April 2002 and vested at 76.29% at the end of the performance period on 31 December 2004.
** The exercise and vesting of awards in 2004 for Mr McLuskie occurred after his retirement from the Board on 23 August 2004.

Note:

The vesting of option-based awards under the MPP does not trigger any payment to participants. Values shown at the time of vesting in the above table illustrate the potential value of the award at that time. For any awards that have vested, participants holding option-based awards can exercise their right over the underlying share equivalents at any time up to ten years from the date of grant.

No variation was made to any of the terms of the plan during the year. The performance measures are detailed on page 71.

*Phantom 2000 Plan*

| | | Awards granted during year | | | | |
|---|---|---|---|---|---|---|
| | Phantom 2000 units at 1 January 2004 | Units awarded during year | Market price on award | End of the period for qualifying conditions to be fulfilled | Benefits received during year | Phantom 2000 units at 31 December 2004 |
| Mr Fish | 1,000,000 | | | 01.01.04 | | 1,000,000 |
| | 1,000,000 | | | 01.01.05 | | 1,000,000 |
| | 2,000,000 | | | | | 2,000,000 |

No variation was made to any of the terms of the plan during the year. The performance measures are detailed on page 72.

*Citizens Long Term Incentive Plan*

| | Interests at 1 January 2004 | Awards granted during year | Benefits received during year | Interests at 31 December 2004 |
|---|---|---|---|---|
| Mr Fish | LTIP* awards for the 3 year periods:<br>01.01.01 – 31.12.03<br>01.01.02 – 31.12.04<br>01.01.03 – 31.12.05 | LTIP award for the 3 year period:<br>01.01.04 – 31.12.06 | LTIP award for the 3 year period:<br>01.01.01 – 31.12.03<br>was $1,020,831 | LTIP* awards for the 3 year periods:<br>01.01.02 – 31.12.04<br>01.01.03 – 31.12.05<br>01.01.04 – 31.12.06 |

* Under the cash LTIP, target payment is 60% of average salary over the three year period, maximum payment is 105% of average salary. No variation was made to any of the terms of the plan during the year. The performance measures are detailed on page 72.

*Directors pension arrangements*

During the year, Sir Fred Goodwin, Norman McLuskie, Gordon Pell, Iain Robertson and Fred Watt participated in The Royal Bank of Scotland Group Pension Fund (the RBS Fund). The RBS Fund is a defined benefit fund which provides pensions and other benefits within Inland Revenue limits.

The pension entitlements of Sir Fred Goodwin, Mr Pell, Mr Robertson, and Mr Watt within the RBS Fund are restricted by Inland Revenue limits as set out in the Finance Act 1989. Additional life assurance cover in excess of these limits is provided by a separate arrangement. Arrangements have been made to provide Sir Fred Goodwin and Mr Pell with additional pension benefits on a defined benefit basis outwith the RBS Fund. The figures shown below include the accrual in respect of these arrangements. Mr Watt is provided with additional pension benefits on a defined contribution basis and contributions made in the year are shown below.

Sir George Mathewson receives life insurance cover under an individual arrangement. The non-executive directors do not accrue pension benefits, other than Mr Robertson who continues to accrue benefits in the RBS Fund after his appointment as a non-executive director.

Lawrence Fish accrues pension benefits under a number of arrangements in the USA. Defined benefits are built up under the Citizens Qualified Plan, Excess Plan and Supplemental Executive Retirement Arrangement. In addition, he is a member of two defined contribution arrangements  a Qualified 401(k) Plan and an Excess 401(k) Plan.

As in the 2003 Report and Accounts, disclosure of these benefits has been made in accordance with the Stock Exchange Listing Rules and the Combined Code and with the Directors Remuneration Report Regulations 2002.

| Defined benefit arrangements | Age at 31 December 2004 | Accrued entitlement at 31 December 2004 000 p.a. | Additional pension earned during the year ended 31 December 2004 000 p.a. | Additional pension earned during the year ended 31 December 2004* 000 p.a. | Transfer value as at 31 December 2004 000 | Transfer value as at 31 December 2003 000 | Increase in transfer value during year ended 31 December 2004 000 | Transfer value for the additional pension earned during the year ended 31 December 2004* 000 |
|---|---|---|---|---|---|---|---|---|
| Sir Fred Goodwin | 46 | £ 381 | £ 56 | £ 48 | £ 3,591 | £ 2,674 | £ 917 | £ 448 |
| Mr McLuskie | 60 | £ 205 | £ 11 | £ 7 | £ 3,430 | £ 3,358 | £ 72 | £ 87 |
| Mr Pell | 54 | £ 247 | £ 18 | £ 12 | £ 3,592 | £ 2,930 | £ 662 | £ 171 |
| Mr Robertson | 59 | £ 32 | £ 4 | £ 3 | £ 565 | £ 449 | £ 116 | £ 45 |
| Mr Watt | 44 | £ 7 | £ 2 | £ 2 | £ 62 | £ 40 | £ 22 | £ 15 |
| Mr Fish | 60 | $ 1,140 | $ 257 | $ 257 | $ 10,046 | $ 9,966 | $ 80 | $ 2,269 |

* net of statutory revaluation applying to deferred pensions

Notes:

(1) There is a significant difference in the form of disclosure required by the Combined Code and the Directors Remuneration Report Regulations 2002. The former requires the disclosure of the additional pension earned during the year and the transfer value equivalent to this pension based on stock market conditions at the end of the year. The latter requires the disclosure of the difference between the transfer value at the start and end of the year and is

therefore dependent on the change in stock market conditions over the course of the year. The above disclosure has been made in accordance with the Combined Code and the Directors Remuneration Report Regulations 2002.

(2) Mr McLuskie retired on 23 August 2004 at his normal pension age. The figures for him above have been calculated as at his retirement date rather than 31 December 2004.

(3) The figures for Mr Pell include an additional pension secured by a transfer from his previous employer which increases in line with statutory revaluation, not salary inflation.

(4) The transfer values disclosed above do not represent a sum paid or payable to the individual director. Instead they represent a potential liability of the company /pension scheme.

(5) The transfer value for Mr Fish as at 31 December 2004 is based on a retirement age of 65.

Contributions and allowances paid in the year ended 31 December 2004 under defined contribution arrangements were:

| | | 2004 000 | | 2003 000 |
|---|---|---|---|---|
| Mr Watt | £ | 128 | £ | 109 |
| Mr Fish | $ | 91 | $ | 90 |

Bob Scott, Chairman of the Remuneration Committee
23 February 2005



## Directors interests in shares

*Ordinary shares*

The following directors held a beneficial interest in the company s ordinary shares:

| | 31 December 2004 | 1 January 2004 or date of appointment if later | | 31 December 2004 | 1 January 2004 or date of appointment if later |
|---|---|---|---|---|---|
| Mr Buchan | 5,000 | 5,000 | Sir George Mathewson | 250,816 | 247,978 |
| Mr Fish | 11,120 | 11,120 | Mr Pell | 582 | 582 |
| Sir Fred Goodwin | 64,960 | 64,718 | Mr Robertson | 129,632 | 125,139 |
| Mr Hunter | 1,500 | 1,500 | Mr Scott | 2,448 | 1,445 |
| Mr Koch | 20,000 | 20,000 | Lord Vallance | 2,500 | 2,500 |
| Mr MacHale | 10,000 |  | Mr Watt | 58,408 | 7,453 |
| Miss Mackay | 6,341 | 6,140 | | | |

No other director had an interest in the company s ordinary shares during the year.

On both 7 January 2005 and 7 February 2005, seven ordinary shares of 25p each were acquired by Sir Fred Goodwin under the Group s Buy As You Earn share scheme.

*Preference shares*

Lawrence Fish held 20,000 non-cumulative preference shares of US$0.01 each at 31 December 2004 (2003  20,000). No other director had an interest in the preference shares during the year.

*Loan notes*

No director had an interest in loan notes during the year.

The company's Register of Directors' Interests, which is open to inspection, contains full details of directors' shareholdings and options to subscribe.

No director held a non-beneficial interest in the shares of the company at 31 December 2004, at 1 January 2004 or date of appointment if later.



## Statement of directors' responsibilities

United Kingdom company law requires the directors to prepare accounts for each financial year which give a true and fair view of the state of affairs of the company and of the Group as at the end of the financial year and of the profit or loss of the Group for that year. In preparing those accounts, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent; and
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the accounts.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and to enable them to ensure that the accounts comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

By order of the Board.

Miller McLean
*Secretary*
23 February 2005

82

**Financial statements**

# Contents


| | |
|---|---|
| **84** | Independent auditors report |
| **85** | Accounting policies |
| **89** | Consolidated profit and loss account |
| **90** | Consolidated balance sheet |
| **91** | Statement of consolidated total recognised gains and losses |
| **91** | Reconciliation of movements in consolidated shareholders funds |
| **92** | Consolidated cash flow statement |
| **93** | Balance sheet  the company |
| **94** | Notes on the accounts |


83

## Report of Independent registered public accounting firm to the members of The Royal Bank of Scotland Group plc

We have audited the financial statements of The Royal Bank of Scotland Group plc ("the company") and its subsidiaries (together "the Group") for the year ended 31 December 2004 which comprise the accounting policies, the profit and loss account, the balance sheets, the cash flow statement, the statement of total recognised gains and losses, the reconciliation of movements in shareholders funds and the related Notes 1 to 55. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the part of the directors’ remuneration report that is described as having been audited.

*Respective responsibilities of directors and auditors*

As described in the ‘Statement of directors’ responsibilities’, the company’s directors are responsible for the preparation of the financial statements in accordance with applicable United Kingdom law and accounting standards. They are also responsible for the preparation of the other information contained in the 2004 Annual Report on Form 20-F including the directors’ remuneration report. Our responsibility is to audit the financial statements and the part of the directors’ remuneration report described as having been audited in accordance with relevant United Kingdom legal and regulatory requirements and auditing standards.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the directors’ remuneration report described as having been audited have been properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the directors’ report is not consistent with the financial statements, if the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors’ remuneration and transactions with the company and other members of the Group is not disclosed.

We review whether the corporate governance statement reflects the company's compliance with the nine provisions of the Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the directors’ report and the other information contained in the 2004 Annual Report on Form 20-F as described in the contents section including the unaudited part of the directors’ remuneration report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements.

*Basis of audit opinion*

We conducted our audit in accordance with United Kingdom auditing standards issued by the Auditing Practices Board and with the standards of the United States Public Company Accounting Oversight Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the directors’ remuneration report described as having been audited. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group’s internal control over financial reporting. Accordingly, we express no such opinion. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements and of whether the accounting policies are appropriate to the circumstances of the company and the Group, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the directors’ remuneration report described as having been audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the directors’ remuneration report described as having been audited.

*UK opinion*

In our opinion the financial statements give a true and fair view of the state of affairs of the company and the Group as at 31 December 2004 and of the profit and cash flows of the Group for the year then ended and the financial statements and the part of the directors’ remuneration report described as having been audited have been properly prepared in accordance with the Companies Act 1985.

*US opinion*

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Group as at 31 December 2004 and 2003 and the results of its operations and its cash flows for each of the three years in the period ended 31 December 2004 in conformity with accounting principles generally accepted in the United Kingdom.

As discussed in Note 1, the Group has adopted Financial Reporting Standard 17 Retirement Benefits. As required by accounting principles generally accepted in the United Kingdom, the financial position of the Group, the results of its operations and its cash flows for 2003 and 2002 have been restated and are presented on a comparable basis.

Accounting principles generally accepted in the United Kingdom vary in certain significant respects from accounting principles generally accepted in the United States of America. The application of the latter would have affected the determination of net income for each of the three years in the period ended 31 December 2004 and the determination of shareholders equity as at 31 December 2004 and 2003, to the extent summarised in Note 53 to the financial statements.

Deloitte & Touche LLP
Chartered Accountants and Registered Auditors
Edinburgh
23 February 2005



## Accounting policies

The accounts have been prepared in accordance with applicable Accounting Standards in the UK and the Statements of Recommended Accounting Practice issued by the British Bankers Association and by the Finance and Leasing Association. The Statement of Recommended Practice issued by the Association of British Insurers (2003) has been followed by the insurance members of the Group; they have been consolidated in the recognised manner for banking groups, in particular, by using the embedded value method for life business. A summary of the more important accounting policies is set out below. The consolidated accounts are prepared in accordance with the special provisions of Part VII of the Companies Act 1985 (the Act) relating to banking groups.

The accounts of the company are prepared in accordance with section 226 of, and Schedule 4 to, the Act and, as permitted by section 230(3) of the Act, no profit and loss account is presented.

*Change of accounting policy*

FRS 17 Retirement Benefits (FRS 17) supersedes Statement of Standard Accounting Practice 24 'Pension costs (SSAP24) and the Urgent Issues Task Force Abstract 6 Accounting for post-retirement benefits other than pensions. All the disclosure requirements of FRS 17 were adopted by the Group in its 2002 financial statements. In November 2002, the Accounting Standards Board deferred the effective date of the recognition and measurement elements of the standard to accounting periods beginning on or after 1 January 2005. The Group has, however, implemented the recognition and measurement provisions of FRS 17 in 2004 in the light of the introduction of International Financial Reporting Standards from 1 January 2005; the measurement principles in the equivalent international accounting standard (IAS 19 Employee Benefits) are similar to those in FRS 17.

FRS 17 requires assets in a defined benefit scheme to be measured at their fair value at the balance sheet date. Scheme liabilities are measured using the projected unit method, which takes account of projected earnings increases, using actuarial assumptions that are mutually compatible and lead to the best estimate of the future cash flows. These cash flows are discounted at the interest rate applicable to high-quality corporate bonds of the same currency and term as the liabilities. The surplus/deficit in a defined benefit scheme is the excess/shortfall of the value of the assets in the scheme over/below the value of the scheme liabilities. A surplus is recognised as an asset to the extent that the employer is able to recover the surplus either through reduced contributions in the future or through refunds from the scheme. A deficit is recognised as a liability to the extent of the employer’s legal or constructive obligation to fund it. The current service cost (the increase in scheme liabilities arising from employee service in the current period), past service costs (the cost of improvements to benefits for service relating to prior periods) and interest cost (the unwind of the discount on scheme liabilities) net of the expected return on scheme assets are charged to the profit and loss account. Actuarial gains and losses (changes in surpluses or deficits due to experience gains and losses and to changes in actuarial assumptions) are recognised in full in the statement of total recognised gains and losses for the period. Under SSAP24 for the main defined benefit scheme the profit and loss account charge comprised the cost of accruing benefits for active employees and the amortisation of the surplus recognised on the acquisition of NatWest offset by a credit for the amortisation of the scheme surplus. A pension prepayment was included in the Group’s balance sheet.

The effect of this change of policy on the profit and loss account has been to credit £85 million (2003 – £52 million; 2002 – £201 million) to Other operating income and to increase Administrative expenses – staff costs by £217 million (2003 –£135 million; 2002 – £112 million). Profit before tax has been reduced by £132 million (2003 – £83 million; 2002 – increased by £89 million). A deficit, net of deferred tax, of £1,901 million (2003 – £1,445 million) has been recognised on the balance sheet; Prepayments and accrued income of £1,079 million (2003 – £112 million), Other assets of £654 million (2003 – £735 million) and Accruals and deferred income of £26 million (2003 – £18 million) have been eliminated; the liability for deferred taxation has reduced by £315 million (2003 – £230 million) and the Deferred tax asset (within Other assets) has increased by £19 million (2003 – £20 million). Other provisions have decreased by £73 million (2003 – £43 million) and shareholders’ funds by £3,220 million. A prior year adjustment of £2,001 million is shown in the Statement of consolidated total recognised gains and losses. The prior year adjustment comprises: the recognition of the pension deficit at 31 December 2003 of £1,414 million (£1,968 million less deferred tax of £554 million); the elimination of pension prepayments less accruals of £58 million (net of deferred tax); and the elimination of the pension surplus recognised on the acquisition of NatWest amounting to £529 million (net of deferred tax and amortisation).

*1 Accounting convention and bases of consolidation*

The accounts are prepared under the historical cost convention modified by the periodic revaluation of premises and certain investments. To avoid undue delay in the presentation of the Group’s accounts, the accounts of certain subsidiary undertakings have been made up to 30 November. There have been no changes in respect of these subsidiary undertakings, in the period from their balance sheet dates to 31 December, that materially affect the view given by the Group’s accounts.

*2 Revenue recognition*

Interest is credited to the profit and loss account as it accrues unless there is significant doubt that it can be collected (as described in the accounting policy on loans and advances).

Fees in respect of services are recognised as the right to consideration accrues through performance to customers. Services are in respect of financial services related products, the arrangement is generally contractual, the cost of providing this service is incurred as the service is rendered and the price is usually fixed and always determinable. The application of the Group’s policy to significant fee types is outlined below.

Loan origination fees: up-front lending fees are recognised as income when receivable except where they are charged in lieu of interest or charged to cover the cost of a continuing service to the borrower, in which case they are credited to income over the life of the advance.

Commitment and utilisation fees: these are generally determined as a percentage of the outstanding used or unused facility. They are usually charged to the customer in arrears and recognised when charged.

Payment services: this comprises income received for payment services including cheques cashed, direct debits, Clearing House Automated Payments (the UK electronic settlement system) and BACS payments (the automated clearing house that processes direct debits and direct credits). These are generally charged on a per transaction basis. The income is earned when the payment or transaction occurs. Payment services income is usually charged to the customer's account, monthly or quarterly in arrears. Accruals are raised for services provided but not charged at period end.

Card related services: fees from credit card business include:

> Commission received from retailers for processing credit and debit card transactions: income is accrued to the profit and loss account as the service is performed.
>
> Interchange received: as issuer, the Group receives a fee (interchange) each time a cardholder purchases goods and services. The Group also receives interchange fees from other card issuers for providing cash advances through its branch and Automated Teller Machine networks. These fees are accrued once the transaction has taken place.
>
> An annual fee payable by a credit card holder is charged at the beginning of each year but is deferred and taken to income over the period of the service i.e. 12 months.

Insurance brokerage: this is made up of fees and commissions received from the agency sale of insurance. Commission on the sale of an insurance contract is earned at the inception of the policy as the insurance has been arranged and placed. However, provision is made where commission is refundable in the event of policy cancellation in line with estimated cancellations.

Securities and derivatives held for trading are recorded at fair value. Changes in fair value are recognised in dealing profits together with dividends from, and interest receivable and payable on, trading business assets and liabilities.

*3 Goodwill*

Goodwill is the excess of the cost of acquisition of subsidiary and associated undertakings over the fair value of the Group's share of net tangible assets acquired. Goodwill arising on acquisitions of subsidiary and associated undertakings after 1 October 1998 is capitalised on the balance sheet and amortised on a straight-line basis over its estimated useful economic life, currently over periods up to 20 years. Capitalised goodwill is reviewed for impairment at the end of the first full year following an acquisition and subsequently if events or changes in circumstances indicate that its carrying value may not be recoverable in full. Goodwill arising on acquisitions of subsidiary and associated undertakings prior to 1 October 1998, previously charged directly against profit and loss account reserves, was not reinstated under the transitional provisions of FRS 10 "Goodwill and Intangible Assets". It will be written back only on disposal and reflected in the calculation of the gains or losses arising.

*4 Foreign currencies*

Monetary assets and liabilities denominated in foreign currencies are translated into sterling at the rates of exchange ruling at the balance sheet date. Profit and loss accounts of overseas branches and subsidiary undertakings are translated at the average rates of exchange for the period. Exchange differences arising from the application of closing rates of exchange to the opening net assets of overseas branches and subsidiary undertakings and from restating their results from average to period-end rates are taken to profit and loss account reserves, together with exchange differences arising on related foreign currency borrowings. All other exchange differences are included in operating profit.

*5 Pensions and other post-retirement benefits*

The Group provides retirement benefits, in the form of pensions and healthcare plans, to eligible employees. Defined benefit scheme liabilities are measured on an actuarial basis using the projected unit method and discounted at a rate that equals the current rate of return on a high quality corporate bond of equivalent term and currency to the scheme liabilities. Scheme assets are measured at their fair value. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit), net of related notional deferred tax. An asset is only recognised to the extent that the surplus can be recovered through reduced contributions in the future or through refunds from the scheme.

The current service cost and any past service costs are charged to the profit and loss account within Administrative expenses – staff costs. The expected return on scheme assets less the unwinding of the discount on the scheme liabilities is included in Other operating income. Actuarial gains and losses are recognised in the statement of total recognised gains and losses, net of related notional deferred tax.

*6 Leases*

Contracts to lease assets and hire purchase agreements are classified as finance leases if they transfer substantially all the risks and rewards of ownership of the asset to the customer. Other contracts are classified as operating leases. Total gross earnings under finance leases are allocated to accounting periods using the actuarial after tax method to give a constant periodic rate of return on the net cash investment. Finance lease receivables are stated in the balance sheet at the amount of the net investment in the lease. Rental income from operating leases is credited to the profit and loss account on a receivable basis over the term of the lease. Balance sheet carrying values of finance lease receivables and operating lease assets include amounts in respect of the residual values of the leased assets. Unguaranteed residual values are subject to regular review to identify potential impairments. Provisions are made for impairment arising on specific asset categories.



---

*7 General insurance*

General insurance comprises short-duration contracts and include principally property and liability insurance contracts. Due to the nature of the products sold – retail based property and casualty, motor, home and personal health insurance contracts – the insurance protection is provided on an even basis throughout the term of the policy.

In calculating operating profit from general insurance activities, premiums (net of reinsurance premiums) are recognised in the accounting period in which they begin. Unearned premiums represent the proportion of the net premiums that relate to periods of insurance after the balance sheet date and are calculated over the period of exposure under the policy, on a daily basis, 24th’s basis or allowing for the estimated incidence of exposure under policies which are longer than twelve months. Provision is made where necessary for the estimated amount required over and above unearned premiums net of reinsurance, including that in respect of future written business on discontinued lines under the run-off of delegated underwriting authority arrangements. It is designed to meet future claims and related expenses and is calculated across related classes of business on the basis of a separate carry forward of deferred acquisition expenses after making allowance for investment income.

Acquisition expenses relating to new and renewed business for all classes are deferred over the period during which the premiums are unearned. The principal acquisition costs so deferred are commissions payable, direct advertising expenditure, costs associated with the telesales and underwriting staff and prepaid claims handling costs in respect of delegated claims handling arrangements for claims which are expected to occur after the balance sheet date.

Claims (net of reinsurance) are recognised in the accounting period in which the loss occurs. Provision is made for the full cost (net of reinsurance) of settling outstanding claims at the balance sheet date, including claims estimated to have been incurred but not yet reported at that date, and claims handling expenses.

*8 Long-term life assurance business*

The Groups long-term assurance business includes whole-life, guaranteed renewable term life, endowment, annuity and universal life contracts that are expected to remain in force for an extended period of time, generally five to forty years.

The value placed on the Groups long-term life assurance business comprises the net assets of the Groups life assurance subsidiaries, including its interest in the surpluses retained within the long-term assurance funds, and the present value of profits inherent in in-force policies. In calculating the value of in-force policies, future surpluses expected to emerge are estimated using appropriate assumptions as to future mortality, persistency and levels of expenses, which are then discounted at a risk-adjusted rate. Changes in this value, which is determined on a post-tax basis, are included in operating profit, grossed up at the underlying rate of taxation. Long-term assurance assets attributable to policyholders are valued on the following bases: equity shares and debt securities at market price; investment properties and loans at valuation. These assets are held in the life funds of the Groups life assurance companies, and although legally owned by them, the Group only benefits from these assets when surpluses are declared. To reflect the distinct nature of the long-term assurance assets, they are shown separately on the consolidated balance sheet, as are liabilities attributable to policyholders.

The Group has reinsured contracts that transfer significant insurance risk. Within net assets, the reinsurance cash flows are recognised when they become payable. For most contracts this effectively spreads the cost of reinsurance over the life of the reinsured contracts. In some cases, the acquisition costs are financed by the reinsurer offering a nil premium payment period. In these cases, the acquisition costs incurred on the underlying insurance contracts are compared with the benefit arising with respect to the nil premium paying period on the reinsurance contract.

*9 Loans and advances*

The Group makes provisions for bad and doubtful debts, through charges to the profit and loss account, so as to record impaired loans and advances at their expected ultimate net realisable value.

Specific provisions are made against individual loans and advances that the Group no longer expects to recover in full. For the Groups portfolios of smaller balance homogeneous advances, such as credit card receivables, specific provisions are established on a portfolio basis taking into account the level of arrears, security and past loss experience. For loans and advances that are individually assessed, the specific provision is determined from a review of the financial condition of the borrower and any guarantor and takes into account the nature and value of any security held.

The general provision is made to cover bad and doubtful debts that have not been separately identified at the balance sheet date but are known to be present in any portfolio of advances. The level of general provision is determined in the light of past experience, current economic and other factors affecting the business environment and the Groups monitoring and control procedures, including the scope of specific provisioning procedures.

Specific and general provisions are deducted from loans and advances. When there is significant doubt that interest receivable can be collected, it is excluded from the profit and loss account and credited to an interest suspense account. Loans and advances and suspended interest are written off in part or in whole when there is no realistic prospect of recovery.

*10 Taxation*

Provision is made for taxation at current enacted rates on taxable profits taking into account relief for overseas taxation where appropriate. Timing differences arise where gains and losses are accounted for in different periods for financial reporting purposes and for taxation purposes. Deferred taxation is accounted for in full for all such timing differences, except in relation to revaluations of fixed assets where there is no commitment to dispose of the asset, taxable gains on sales

## **Accounting policies** continued

of fixed assets that are rolled over into the tax cost of replacement assets, and unremitted overseas earnings. Deferred tax assets are only recognised to the extent that it is considered more likely than not that they will be recovered. Deferred tax amounts are not discounted.

*11 Debt securities and equity shares*

Debt securities and equity shares intended for use on a continuing basis in the Group's activities are classified as investment securities and are stated at cost less provision for any permanent diminution in value. The cost of dated investment securities is adjusted for the amortisation of premiums or discounts over periods to redemption and the amortisation is included in interest receivable. Other debt securities and equity shares are carried at fair value, with changes in fair value recognised in the profit and loss account.

*12 Shares in subsidiary undertakings*

The company's shares in subsidiary undertakings are stated in the balance sheet of the company at directors' valuation that takes account of the subsidiary undertakings' net asset values.

*13 Tangible fixed assets*

Freehold and long leasehold properties are revalued on a rolling basis, each property being revalued at least every five years. Other tangible fixed assets are stated at cost less depreciation and provisions for impairment. Costs of adapting premises for the use of the Group are separately identified and depreciated.

Tangible fixed assets are depreciated to their residual value over their estimated useful economic lives on a straight-line basis, as follows:

| | |
|---|---|
| Freehold and long leasehold buildings | 50 years |
| Short leaseholds | unexpired period of the lease |
| Property adaptation costs | 10 to 15 years |
| Computer equipment | up to 5 years |
| Other equipment | 4 to 15 years |

Assets on operating leases are depreciated over their estimated useful lives on a straight-line or reverse-annuity basis. Land has an unlimited life and is not depreciated.

Investment properties are revalued annually to open market value. No depreciation is charged on freehold investment properties, in accordance with the requirements of Statement of Standard Accounting Practice 19 'Accounting for investment properties'. This is a departure from the requirements of the Companies Act 1985 which requires all tangible fixed assets to be depreciated. Investment properties are held not for consumption but for investment and the directors consider that to depreciate them would not give a true and fair view. It is not practicable to assess estimated useful lives for investment properties, and accordingly the effect of not depreciating them cannot be reasonably quantified.

*14 Derivatives*

The Group enters into derivative transactions including futures, forwards, swaps and options principally in the interest rate, foreign exchange and equity markets. The accounting treatment for these instruments is dependent upon whether they are entered into for trading or non-trading (hedging) purposes.

*Trading*

Derivatives held for trading purposes are recognised in the accounts at fair value. Gains or losses arising from changes in fair value are included in dealing profits in the consolidated profit and loss account. Fair value is based on quoted market prices. Where representative market prices are not available, the fair value is determined from current market information using appropriate pricing or valuation models. Adjustments are made to quoted market prices where appropriate to cover credit risk, liquidity risk and future operational costs. In the consolidated balance sheet, positive fair values (assets) of trading derivatives are included in Other assets and negative fair values (liabilities) in Other liabilities. Positive and negative fair values of trading derivatives are offset where the contracts have been entered into under master netting agreements or other arrangements that give a legally enforceable right of set-off.

*Non-trading*

Non-trading derivatives are entered into by the Group to hedge exposures arising from transactions entered into in the normal course of banking activities. They are recognised in the accounts in accordance with the accounting treatment of the underlying transaction or transactions being hedged. To be classified as non-trading, a derivative must match or eliminate the risk inherent in the hedged item from potential movements in interest rates, exchange rates or market values. In addition, there must be a demonstrable link to an underlying transaction, pool of transactions or specified future transaction or transactions. Specified future transactions must be reasonably certain to arise for the derivative to be accounted for as a hedge. In the event that a non-trading derivative transaction is terminated or ceases to be an effective hedge, the derivative is re-measured at fair value and any resulting profit or loss amortised over the remaining life of the underlying transaction or transactions being hedged. If a hedged item is derecognised, or a specified future transaction is no longer likely to occur, the related non-trading derivative is remeasured at fair value and the resulting profit or loss taken to the profit and loss account.

*15 Sale and repurchase transactions*

Securities which have been sold with an agreement to repurchase continue to be shown on the balance sheet and the sale proceeds recorded as a deposit. Securities acquired in reverse sale and repurchase transactions are not recognised in the balance sheet and the purchase price is treated as a loan. The difference between the sale price and repurchase price is accrued evenly over the life of the transaction and charged or credited to the profit and loss account as interest payable or receivable.

88

## Consolidated profit and loss account

for the year ended 31 December 2004

| | Note | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|---|
| Interest receivable | | | | |
|  interest receivable and similar income arising from debt securities | | 1,517 | 1,519 | 1,591 |
|  other interest receivable and similar income | | 15,179 | 12,479 | 11,970 |
| Interest payable | | (7,488) | (5,697) | (5,712) |
| **Net interest income** | | 9,208 | 8,301 | 7,849 |
| Dividend income | | 79 | 58 | 58 |

| | | | | |
|---|---|---|---|---|
| Fees and commissions receivable | | 6,634 | 5,693 | 5,249 |
| Fees and commissions payable | | (1,954) | (1,337) | (965) |
| Dealing profits | 1 | 1,988 | 1,793 | 1,462 |
| Other operating income | | 1,855 | 1,650 | 1,410 |
| | | 8,602 | 7,857 | 7,214 |
| General insurance | | | | |
| – earned premiums | | 5,357 | 3,627 | 2,442 |
| – reinsurance | | (413) | (504) | (489) |
| **Non-interest income** | | 13,546 | 10,980 | 9,167 |
| **Total income** | | 22,754 | 19,281 | 17,016 |
| Administrative expenses | | | | |
| – staff costs** | 2 | 5,344 | 4,653 | 4,584 |
| – premises and equipment** | | 1,184 | 1,073 | 1,006 |
| – other** | | 2,296 | 2,108 | 2,253 |
| Depreciation and amortisation | | | | |
| – tangible fixed assets** | 20 | 1,107 | 919 | 895 |
| – goodwill | 19 | 915 | 763 | 731 |
| **Operating expenses** | | 10,846 | 9,516 | 9,469 |
| **Profit before other operating charges** | | 11,908 | 9,765 | 7,547 |
| General insurance | | | | |
| – gross claims | | 3,724 | 2,644 | 1,693 |
| – reinsurance | | (244) | (449) | (343) |
| **Profit before provisions for bad and doubtful debts** | | 8,428 | 7,570 | 6,197 |
| Provisions for bad and doubtful debts | 13 | 1,428 | 1,461 | 1,286 |
| Amounts written off fixed asset investments | | 83 | 33 | 59 |
| **Profit on ordinary activities before tax** | 4 | 6,917 | 6,076 | 4,852 |
| Tax on profit on ordinary activities | 5 | 2,155 | 1,888 | 1,582 |
| **Profit on ordinary activities after tax** | | 4,762 | 4,188 | 3,270 |
| Minority interests (including non-equity) | 32 | 250 | 210 | 133 |
| **Profit for the financial year** | | 4,512 | 3,978 | 3,137 |
| Preference dividends – non-equity | 6 | 256 | 261 | 305 |
| | | 4,256 | 3,717 | 2,832 |
| Additional Value Shares dividend – non-equity | 6 | –– | 1,463 | 798 |
| **Profit attributable to ordinary shareholders** | | 4,256 | 2,254 | 2,034 |
| Ordinary dividends | 7 | 1,837 | 1,490 | 1,267 |
| **Retained profit** | 34 | 2,419 | 764 | 767 |

| | | | | |
|---|---|---|---|---|
| **Per 25p ordinary share:** | | | | |
| **Basic earnings** | 9 | 138.0p | 76.9p | 70.6p |
| **Diluted earnings** | 9 | 136.9p | 76.3p | 69.6p |
| **Dividends** | 7 | 58.0p | 50.3p | 43.7p |

All items dealt with in arriving at profit on ordinary activities before tax relate to continuing operations.

Profit on ordinary activities before taxation and the retained profit for the year on a historical cost basis were not materially different from the reported amounts.

* restated (see page 85)
** includes integration expenditure (see Note 4)

89

## Consolidated balance sheet

at 31 December 2004

| | Note | 2004 £m | 2003* £m |
|---|---|---|---|
| **Assets** | | | |
| Cash and balances at central banks | | 4,293 | 3,822 |
| Items in the course of collection from other banks | | 2,629 | 2,501 |
| Treasury bills and other eligible bills | 10 | 6,110 | 4,846 |
| Loans and advances to banks | 11 | 58,260 | 51,891 |
| *Loans and advances to customers* | | *350,229* | *253,392* |
| *Less: non-returnable finance* | *12* | *4,760* | *861* |
| | 12 | 345,469 | 252,531 |
| Debt securities | 15 | 91,211 | 79,949 |
| Equity shares | 16 | 2,960 | 2,300 |
| Intangible fixed assets | 19 | 17,576 | 13,131 |
| Tangible fixed assets | 20 | 16,294 | 13,927 |
| Settlement balances | | 5,682 | 2,857 |
| Other assets | 21 | 22,255 | 17,807 |
| Prepayments and accrued income | | 6,928 | 5,309 |
| | | 579,667 | 450,871 |
| Long-term assurance assets attributable to policyholders | 22 | 3,800 | 3,557 |
| **Total assets** | | 583,467 | 454,428 |

| | | | |
|---|---|---|---|
| **Liabilities** | | | |
| Deposits by banks | 23 | 99,081 | 67,323 |
| Items in the course of transmission to other banks | | 802 | 958 |
| Customer accounts | 24 | 285,062 | 236,963 |
| Debt securities in issue | 25 | 58,960 | 41,016 |
| Settlement balances and short positions | 26 | 32,990 | 21,369 |
| Other liabilities | 27 | 26,152 | 20,584 |
| Accruals and deferred income | | 15,588 | 13,155 |
| Post-retirement benefit liabilities | 3 | 1,901 | 1,445 |
| Provisions for liabilities and charges | | | |
| – deferred taxation | 28 | 2,873 | 2,036 |
| – other provisions | 29 | 198 | 213 |
| Subordinated liabilities | | | |
| – dated loan capital | 30 | 11,013 | 9,312 |
| – undated loan capital including convertible debt | 31 | 9,353 | 7,686 |
| Minority interests | | | |
| – equity | | 158 | (11) |
| – non-equity | 32 | 3,671 | 2,724 |
| Called up share capital | 33 | 822 | 769 |
| Share premium account | 34 | 12,964 | 8,175 |
| Merger reserve | 34 | 10,307 | 10,881 |
| Other reserves | 34 | 457 | 419 |
| Revaluation reserve | 34 | 92 | 7 |
| Profit and loss account | 34 | 7,223 | 5,847 |
| *Shareholders' funds* | | | |
| *– equity* | | *27,345* | *23,175* |
| *– non-equity* | *34* | *4,520* | *2,923* |
| | | 579,667 | 450,871 |
| Long-term assurance liabilities attributable to policyholders | 22 | 3,800 | 3,557 |
| **Total liabilities** | | 583,467 | 454,428 |
| **Memorandum items** | | | |
| Contingent liabilities | 41 | 16,093 | 14,864 |
| Commitments (standby facilities, credit lines and other) | 41 | 180,777 | 139,693 |

* restated (see page 85)

The accounts were approved by the Board of directors on 23 February 2005 and signed on its behalf by:

| | | |
|---|---|---|
| Sir George Mathewson | Sir Fred Goodwin | Fred Watt |
| *Chairman* | *Group Chief Executive* | *Group Finance Director* |

## Statement of consolidated total recognised gains and losses

for the year ended 31 December 2004

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Profit attributable to ordinary shareholders | 4,256 | 2,254 | 2,034 |
| *Actuarial (losses)/gains* | *(1,598)* | *69* | *(2,392)* |
| *Current tax relief* | *56* | — | — |
| *Deferred tax asset/(liability)* | *408* | *(33)* | *700* |
| Actuarial (losses)/gains recognised in post-retirement benefit schemes | (1,134) | 36 | (1,692) |
| *Currency translation adjustments and other movements* | *(399)* | *48* | *37* |
| *Revaluation of premises* | *56* | *(69)* | *(33)* |
| Other recognised (losses)/gains | (343) | (21) | 4 |
| **Total recognised gains and losses in the year** | 2,779 | 2,269 | 346 |
| Prior year adjustment arising from the implementation of FRS 17 | (2,001) | | |
| **Total recognised gains and losses since 31 December 2003** | 778 | | |

## Reconciliation of movements in consolidated shareholders' funds

for the year ended 31 December 2004

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Profit attributable to ordinary shareholders | 4,256 | 2,254 | 2,034 |
| Ordinary dividends | (1,837) | (1,490) | (1,267) |
| Retained profit for the year | 2,419 | 764 | 767 |
| Issue of ordinary and preference shares | 4,603 | 775 | 560 |
| Conversion of exchangeable undated loan capital | 460 | — | — |
| Redemption of preference shares | — | (364) | (600) |
| Actuarial (losses)/gains recognised in post-retirement benefit schemes | (1,134) | 36 | (1,692) |
| Own shares held in relation to employee share scheme | (7) | — | — |
| Goodwill previously written off to reserves | — | 40 | — |
| Other recognised gains and losses | (343) | (21) | 4 |
| Currency translation adjustment on share premium account | (231) | (203) | (283) |
| **Net increase/(decrease) in shareholders' funds** | 5,767 | 1,027 | (1,244) |

| | | | |
|---|---|---|---|
| Opening shareholders’ funds as previously reported | 28,099 | 27,052 | 26,668 |
| Prior year adjustment arising from the implementation of FRS 17 | (2,001) | (1,981) | (353) |
| Opening shareholders’ funds as restated | 26,098 | 25,071 | 26,315 |
| Net increase/(decrease) in shareholders funds | 5,767 | 1,027 | (1,244) |
| **Closing shareholders’ funds** | 31,865 | 26,098 | 25,071 |

* restated (see page 85)



## Consolidated cash flow statement

for the year ended 31 December 2004

| | Note | 2004 £m | 2004 £m | 2003 £m | 2003 £m | 2002 £m | 2002 £m |
|---|---|---|---|---|---|---|---|
| **Net cash inflow from operating activities** | 43 | | 6,307 | | 19,708 | | 13,737 |
| **Dividends received from associated undertakings** | | | 9 | | 9 | | 1 |
| **Returns on investments and servicing of finance** | | | | | | | |
| Preference dividends paid | | (253) | | (269) | | (317) | |
| Additional Value Shares dividend paid | | — | | (1,463) | | (798) | |
| Dividends paid to minority shareholders in subsidiary undertakings | | (204) | | (130) | | (112) | |
| Interest paid on subordinated liabilities | | (613) | | (557) | | (674) | |
| **Net cash outflow from returns on investments and servicing of finance** | | | (1,070) | | (2,419) | | (1,901) |
| **Taxation** | | | | | | | |
| UK tax paid | | (812) | | (933) | | (833) | |
| Overseas tax paid | | (582) | | (521) | | (274) | |
| **Net cash outflow from taxation** | | | (1,394) | | (1,454) | | (1,107) |
| **Capital expenditure and financial investment** | | | | | | | |
| Purchase of investment securities | | (41,790) | | (44,861) | | (32,701) | |
| Sale and maturity of investment securities | | 43,022 | | 41,805 | | 26,072 | |
| Purchase of tangible fixed assets | | (4,354) | | (5,017) | | (3,367) | |
| Sale of tangible fixed assets | | 1,596 | | 1,108 | | 811 | |
| **Net cash outflow from capital expenditure and financial investment** | | | (1,526) | | (6,965) | | (9,185) |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Acquisitions and disposals** | | | | | | | |
| Purchase of businesses and subsidiary undertakings (net of cash acquired) | 44 | (7,648) | | (1,748) | | (308) | |
| Investment in associated undertakings | | (48) | | (2) | | (2) | |
| Sale of subsidiary and associated undertakings (net of cash sold) | 45 | 22 | | 179 | | 29 | |
| **Net cash outflow from acquisitions and disposals** | | | (7,674) | | (1,571) | | (281) |
| **Ordinary equity dividends paid** | | | (1,235) | | (772) | | (729) |
| **Net cash (outflow)/inflow before financing** | | | (6,583) | | 6,536 | | 535 |
| **Financing** | | | | | | | |
| Proceeds from issue of ordinary share capital | | 2,845 | | 184 | | 85 | |
| Proceeds from issue of preference share capital | | 1,358 | | — | | — | |
| Proceeds from issue of trust preferred securities | | 1,075 | | 883 | | 1,242 | |
| Redemption of preference share capital | | — | | (364) | | (600) | |
| Issue of subordinated liabilities | | 4,624 | | 3,817 | | 2,157 | |
| Repayment of subordinated liabilities | | (718) | | (336) | | (202) | |
| Increase/(decrease) in minority interests | | 185 | | (56) | | 29 | |
| **Net cash inflow from financing** | | | 9,369 | | 4,128 | | 2,711 |
| **Increase in cash** | 48 | | 2,786 | | 10,664 | | 3,246 |



## Balance sheet — the company

at 31 December 2004

| | Note | 2004 £m | 2003 £m |
|---|---|---|---|
| **Fixed assets** | | | |
| Investments: | | | |
| Shares in Group undertakings | 17 | 36,870 | 32,354 |
| Loans to Group undertakings | 18 | 4,101 | 4,554 |
| | | 40,971 | 36,908 |
| **Current assets** | | | |
| Debtors: | | | |
| Due by subsidiary undertakings | | 458 | 238 |
| Debtors and prepayments | | 174 | 202 |

| | | | |
|---|---|---|---|
| | | 632 | 440 |
| **Creditors** | | | |
| Amounts falling due within one year: | | | |
| Due to banks | | 66 | 71 |
| Dated loan capital | 30 | 40 | 40 |
| Debt securities in issue | | 1,608 | 1,877 |
| Other creditors | | 247 | 217 |
| Proposed final dividend | 7 | 1,308 | 1,059 |
| | | 3,269 | 3,264 |
| **Net current liabilities** | | (2,637) | (2,824) |
| **Total assets less current liabilities** | | 38,334 | 34,084 |
| **Creditors** | | | |
| Amounts falling due beyond one year: | | | |
| Loans from subsidiary undertakings | | 162 | 186 |
| Dated loan capital | 30 | 4,810 | 3,714 |
| Undated loan capital including convertible debt | 31 | 1,085 | 1,639 |
| | | 6,057 | 5,539 |
| **Capital and reserves** | | | |
| Called up share capital | 33 | 822 | 769 |
| Share premium account | 34 | 12,964 | 8,175 |
| Other reserves | 34 | 156 | 156 |
| Revaluation reserve | 34 | 14,970 | 16,857 |
| Profit and loss account | 34 | 3,365 | 2,588 |
| *Shareholders funds* | | | |
| *equity* | | *27,757* | *25,622* |
| *non-equity* | *34* | *4,520* | *2,923* |
| | | 38,334 | 34,084 |

The accounts were approved by the Board of directors on 23 February 2005 and signed on its behalf by:

| | | |
|---|---|---|
| Sir George Mathewson | Sir Fred Goodwin | Fred Watt |
| *Chairman* | *Group Chief Executive* | *Group Finance Director* |

# Notes on the accounts

## 1 Dealing profits

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Foreign exchange (1) | 616 | 540 | 447 |
| Securities | | | |
| Equities (2) | 36 | 24 | 18 |
| Debt (3) | 811 | 774 | 644 |
| Interest rate derivatives (4) | 525 | 455 | 353 |
| | 1,988 | 1,793 | 1,462 |

Dealing profits include interest income and expense recognised on trading-related interest-earning assets and interest-bearing liabilities and exclude direct costs and administrative expenses.

Notes:

(1) Includes spot and forward foreign exchange contracts and currency swaps, futures and options and related hedges and funding.

(2) Includes equities, equity derivatives, commodity contracts and related hedges and funding.

(3) Includes debt securities and related hedges and funding.

(4) Includes interest rate swaps, forward rate agreements, interest rate options, interest rate futures and credit derivatives and related hedges and funding.

## 2 Administrative expenses – staff costs

| | 2004 £m | 2003* £m | 2002* £m |
|---|---|---|---|
| Wages, salaries and other staff costs | 4,543 | 3,997 | 4,001 |
| Social security costs | 295 | 248 | 239 |
| Pension costs (see Note 3) | 506 | 408 | 344 |
| | 5,344 | 4,653 | 4,584 |

* restated (see page 85)

The average number of persons employed by the Group during the year, excluding temporary staff, was 133,300 (2003 – 119,500; 2002 – 113,500).

## 3 Pension costs

The Group operates a number of pension schemes which are predominantly defined benefit schemes whose assets are independent of the Group's finances. In addition to the main scheme, The Royal Bank of Scotland Group Pension Fund, the Group operates a number of other UK and overseas pension schemes. It also provides other post-retirement benefits, principally through subscriptions to private healthcare schemes in the UK and the US and unfunded post-retirement benefit plans. Provision for the costs of these benefits is charged to the profit and loss account over the average remaining future service lives of the eligible employees. The amounts are not material.

The total pension costs for the Group were as follows:

| Amount charged to profit and loss account | Main UK scheme £m | Other schemes £m | 2004 Total £m | 2003 Total £m | 2002 Total £m |
|---|---|---|---|---|---|
| Expected return on pension scheme assets | (840) | (82) | (922) | (826) | (988) |
| Interest on pension scheme liabilities | 759 | 78 | 837 | 774 | 787 |
| Net return credited to other operating income | (81) | (4) | (85) | (52) | (201) |
| Current service cost | 400 | 51 | 451 | 371 | 322 |
| Past service cost | – | 11 | 11 | – | 3 |
| Net pension cost defined benefit schemes | 319 | 58 | 377 | 319 | 124 |
| Defined contribution schemes and other retirement benefits | – | 44 | 44 | 37 | 19 |
| Total net pension costs | 319 | 102 | 421 | 356 | 143 |

| The total net pension costs are included in the profit and loss account as follows: | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Other operating income | (85) | (52) | (201) |
| Staff costs – pension costs (see Note 2) | 506 | 408 | 344 |
| Total net pension costs | 421 | 356 | 143 |



For the purposes of FRS 17, interim valuations of the Group's schemes were prepared to 31 December by independent actuaries, using the following assumptions:

| | 2004 | | 2003 | | |
|---|---|---|---|---|---|
| | Main UK scheme | Other Group schemes* | Main UK scheme | Other Group schemes* | Main UK scheme |
| Rate of increase in salaries (per annum) | 3.95% | 3.6% | 3.95% | 3.8% | 3.50% |
| Rate of increase in pensions in payment (per annum) | 2.70% | 2.5% | 2.70% | 2.3% | 2.25% |
| Discount rate (per annum) | 5.40% | 5.2% | 5.60% | 5.8% | 5.75% |
| Inflation assumption (per annum) | 2.70% | 2.5% | 2.70% | 2.1% | 2.25% |

* weighted average

The assets and liabilities of the schemes were as follows:

| | 2004 | 2003 | 2 |
|---|---|---|---|

| | Main UK scheme £m | Other Group schemes £m | Main UK scheme £m | Other Group schemes £m | Main UK schemes £m |
|---|---|---|---|---|---|
| Equities | 7,713 | 777 | 7,621 | 686 | 7,161 |
| Bonds | 2,238 | 244 | 3,818 | 276 | 3,298 |
| Other | 3,647 | 208 | 383 | 103 | 223 |
| Total market value of assets | 13,598 | 1,229 | 11,822 | 1,065 | 10,682 |
| Present value of scheme liabilities | (16,051) | (1,626) | (13,594) | (1,261) | (12,418) |
| Net deficit in the schemes | (2,453) | (397) | (1,772) | (196) | (1,736) |
| Deferred tax asset | 905 | 78 | 532 | 22 | 521 |
| Net pension deficit | (1,548) | (319) | (1,240) | (174) | (1,215) |
| Other unfunded liabilities (net) | — | (34) | — | (31) | — |
| Post-retirement benefit liabilities | (1,548) | (353) | (1,240) | (205) | (1,215) |

The assumptions for long-term rates of return on the principal classes of assets at 31 December 2004 were equities 8.1%, g
bonds 5.4%, property 6.3% and cash and other assets 4.6% (2003 — equities 8.4%, gilts 4.8%, other bonds 5.6%, property 6
other assets 4.9%; 2002 — equities 8.4%, gilts 4.5%, other bonds 5.75%, property 6.5% and cash 4.5%).

| Amount recognised in the statement of consolidated total recognised gains and losses | 2004 £m | 2003 £m |
|---|---|---|
| Actual return less expected return on pension scheme assets | 411 | 872 |
| Experience gains and losses arising on scheme liabilities | (631) | 7 |
| Changes in assumptions underlying the present value of scheme liabilities | (1,378) | (810) |
| Actuarial (losses)/gains | (1,598) | 69 |
| Current tax relief | 56 | — |
| Deferred tax asset/(liability) | 408 | (33) |
| Actuarial (losses)/gains recognised in post-retirement benefit schemes | (1,134) | 36 |

| Movement in pension schemes (deficits)/surpluses during the year | 2004 Total £m | 2003 Total £m |
|---|---|---|
| (Deficit)/surplus in the pension schemes at 1 January | (1,968) | (1,856) |
| Movement in year: | | |
| Current service cost | (451) | (371) |
| Past service cost | (11) | — |
| Contributions | 1,145 | 139 |
| Other operating income | 85 | 52 |
| Actuarial (losses)/gains | (1,598) | 69 |
| Acquisition of subsidiaries | (32) | — |
| Exchange and other movements | (20) | (1) |

| | | |
|---|---|---|
| Deficit in schemes at 31 December | (2,850) | (1,968) |
| Deferred tax asset | 983 | 554 |
| Net pension deficit | (1,867) | (1,414) |
| Other unfunded liabilities (net) | (34) | (31) |
| Post-retirement benefit liabilities | (1,901) | (1,445) |

Following the latest formal valuation carried out by independent actuaries as at 31 March 2004, the contribution rate with effect from 1 April 2004 for the main UK scheme is 21.5% of pensionable salaries (2003 and 2002 – 6.8% based on the valuation as at 31 March 2001). Contributions for 2004 include a lump sum of £750 million paid into the Main Fund in addition to the monthly contributions.



## **Notes on the accounts** continued

### 3 Pension costs *(continued)*

| History of experience gains and losses | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Difference between expected and actual return on scheme assets: | | | |
| Amount | 411 | 872 | (2,645) |
| Percentage of scheme assets | 2.8% | 6.8% | (22.6%) |
| Experience gains and losses on scheme liabilities: | | | |
| Amount | (631) | 7 | (25) |
| Percentage of the present value of scheme liabilities | (3.6%) | – | (0.2%) |
| Total amount recognised in the statement of total recognised gains and losses: | | | |
| Amount | (1,598) | 69 | (2,392) |
| Percentage of the present value of scheme liabilities | (9.0%) | 0.5% | (17.7%) |

### 4 Profit on ordinary activities before tax

Profit on ordinary activities before tax is stated after taking account of the following:

| | | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|---|
| **Income** | Aggregate amounts receivable under finance leases, hire purchase and conditional sale contracts | 1,345 | 1,161 | 1,342 |
| | Aggregate amounts receivable under operating leases | 1,103 | 939 | 811 |
| | Profit on disposal of investment securities | 167 | 172 | 85 |
| | Share of associated undertakings’ net profit | 35 | 12 | 2 |

| | | | | |
|---|---|---|---|---|
| **Expenses** | Operating lease rentals of premises | 338 | 321 | 255 |
| | Operating lease rentals of computers and other equipment | 15 | 13 | 16 |
| | Finance charges on leased assets | 13 | 8 | 23 |
| | Interest on subordinated liabilities | 681 | 551 | 659 |
| | Integration expenditure* relating to: | | | |
| | – acquisition of NatWest | — | 143 | 810 |
| | – other acquisitions | 269 | 86 | 147 |

| | | | |
|---|---|---|---|
| * Integration expenditure comprises: | | | |
| Staff costs | 113 | 125 | 530 |
| Premises and equipment | 34 | 31 | 127 |
| Other administrative expenses | 120 | 73 | 298 |
| Depreciation | 2 | — | 2 |
| | 269 | 229 | 957 |

Auditors' remuneration

Amounts paid to the auditors for statutory audit and other services were as follows:

| | 2004 £m | 2003 £m |
|---|---|---|
| Audit services | | |
| – Statutory audit | 8.2 | 7.2 |
| – Audit related regulatory reporting | 1.1 | 0.6 |
| | 9.3 | 7.8 |
| Further assurance services | 3.0 | 5.7 |
| Tax services | | |
| – Compliance services | 0.2 | 0.1 |
| – Advisory services | 0.2 | 0.5 |
| | 0.4 | 0.6 |
| Other services | 3.0 | 0.7 |
| Total | 15.7 | 14.8 |

The auditors' remuneration for statutory audit work for the company was £0.1 million (2003 – £0.1 million). Non-audit fees paid to the auditors and their associates in the UK was £6.4 million (2003 – £6.2 million).

**5 Tax on profit on ordinary activities**

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Current taxation: | | | |
| UK corporation tax charge for the year at 30% | 1,305 | 1,095 | 909 |
| Over provision in respect of prior periods | (66) | (66) | (13) |
| Relief for overseas taxation | (212) | (211) | (26) |
| | 1,027 | 818 | 870 |
| Overseas taxation: | | | |
| Current year charge | 786 | 538 | 370 |
| Over provision in respect of prior periods | (102) | (11) | (2) |
| | 1,711 | 1,345 | 1,238 |
| Share of associated undertakings | 11 | 2 | 2 |
| Current tax charge for the year | 1,722 | 1,347 | 1,240 |
| Deferred taxation: | | | |
| Origination and reversal of timing differences | 482 | 576 | 398 |
| Over provision in respect of prior periods | (49) | (35) | (56) |
| Tax charge for the year | 2,155 | 1,888 | 1,582 |

The actual tax charge differs from the expected tax charge computed by applying the standard rate of UK corporation tax of 30% as follows:

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Expected tax charge | 2,075 | 1,823 | 1,456 |
| Goodwill amortisation | 241 | 200 | 183 |
| Contributions to employee share schemes | (32) | (35) | (40) |
| Non-deductible items | 227 | 248 | 179 |
| Non-taxable items | (251) | (207) | (188) |
| Capital allowances in excess of depreciation | (415) | (626) | (340) |
| Taxable foreign exchange movements | (10) | 5 | 4 |
| Foreign profits taxed at other rates | 49 | 26 | 2 |
| Unutilised losses brought forward and carried forward | 6 | (15) | [illegible] |
| Current taxation adjustments relating to prior periods | (168) | (77) | (15) |
| Current tax charge for the year | 1,722 | 1,342 | 1,241 |
| Deferred taxation: | | | |
| Origination and reversal of timing differences | 482 | 581 | 397 |
| Adjustments in respect of prior periods | (49) | (35) | (56) |
| Actual tax charge | 2,155 | 1,888 | 1,582 |

The following factors may affect future tax charges:

(1) No deferred tax is recognised on the unremitted reserves of overseas subsidiary and associated undertakings. A substantial proportion of such reserves are required to be retained by the overseas undertakings to meet local regulatory requirements.

(2) Deferred tax assets of £110 million (2003 – £127 million) resulting from tax losses carried forward have not been recognised as there is insufficient evidence that the asset will be recoverable. These assets may be recoverable if the losses can be offset against suitable future taxable profits arising in the same tax jurisdiction.

(3) The fair values of certain financial assets are disclosed in Note 40. The tax that could be payable if these assets were disposed of at the values shown is estimated at £910 million (2003 – £561 million). Because of the nature of these financial assets which are held as part of the banking business, it is not possible to determine the amount that may become payable in the foreseeable future.

(4) Freehold and long leasehold properties are revalued (see Note 20). No provision has been made for deferred tax on gains recognised on revaluing Group properties except where there is a commitment to sell the asset and any taxable gain will not be subject to rollover relief. The tax that could be payable if these assets were disposed of at their revalued amount is estimated at £129 million (2003 – £109 million), including tax on rolled over gains (see (5) below). No such tax is expected to be payable in the foreseeable future.

(5) No provision has been made for deferred tax on certain gains realised on disposals of property and other assets as there is an expectation of rolling over such gains into replacement assets. Expenditure to date on valid replacement assets together with forecasts of future such expenditure indicate that these gains will be available for rollover relief. The tax that could be payable if the conditions for rollover relief were not met is estimated at £16 million (2003 – £68 million).



## **Notes on the accounts** continued

### 6 Preference and Additional Value Shares dividends

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Non-cumulative preference shares of US$0.01 | 105 | 99 | 141 |
| Non-cumulative convertible preference shares of US$0.01 | 90 | 100 | 108 |
| Non-cumulative convertible preference shares of €0.01 | 33 | 37 | 32 |
| Non-cumulative preference shares of €0.01 | 4 | – | – |
| Non-cumulative convertible preference shares of £0.25 | – | – | 1 |
| Non-cumulative convertible preference shares of £0.01 | 15 | 15 | 15 |
| 11% cumulative preference shares of £1 (1) | – | – | – |
| 5.5% cumulative preference shares of £1 (2) | – | – | – |
| Appropriation for premium payable on redemption and issue costs | 9 | 10 | 8 |
| Total preference dividends | 256 | 261 | 305 |
| Additional Value Shares | – | 1,463 | 798 |

| | | | |
|---|---|---|---|
| Total non-equity dividends | 256 | 1,724 | 1,103 |

Notes:

(1) Dividends for the year ended 31 December 2004 amounted to £55,000 (2003 and 2002  £55,000).

(2) Dividends for the year ended 31 December 2004 amounted to £22,000 (2003 and 2002  £22,000).

**7 Ordinary dividends**

| | 2004 p per share | 2003 p per share | 2002 p per share | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|---|---|---|
| Interim | 16.8 | 14.6 | 12.7 | 529 | 431 | 368 |
| Proposed final | 41.2 | 35.7 | 31.0 | 1,308 | 1,059 | 899 |
| Total dividends on equity shares | 58.0 | 50.3 | 43.7 | 1,837 | 1,490 | 1,267 |

**8 Profit dealt with in the accounts of the company**

Of the profit attributable to shareholders, £2,878 million (2003  £2,619 million; 2002  £1,955 million) has been dealt with in the accounts of the company.

**9 Earnings per ordinary share**

The earnings per share are based on the following:

| | 2004 £m | 2003 £m | 2002 £m |
|---|---|---|---|
| Earnings: | | | |
| Profit attributable to ordinary shareholders | 4,256 | 2,254 | 2,034 |
| Add back dividends on dilutive convertible non-equity shares | 66 |  |  |
| Diluted earnings attributable to ordinary shareholders | 4,322 | 2,254 | 2,034 |
| | Number of shares  millions | | |
| Number of ordinary shares: | | | |
| Weighted average number of ordinary shares in issue during the year | 3,085 | 2,931 | 2,881 |
| Effect of dilutive share options and convertible non-equity shares | 73 | 22 | 43 |
| Diluted weighted average number of ordinary shares during the year | 3,158 | 2,953 | 2,924 |

**10 Treasury bills and other eligible bills**

| | 2004 £m | 2003 £m |
|---|---|---|
| Treasury bills and similar securities | 5,538 | 3,917 |
| Other eligible bills | 572 | 929 |
| | 6,110 | 4,846 |
| Banking business | 3,189 | 2,977 |
| Trading business | 2,921 | 1,869 |

Treasury and other eligible bills are principally of short-term maturity and their market value is not materially different from carrying value.

**11 Loans and advances to banks**

| | 2004 £m | 2003 £m |
|---|---|---|
| Repayable on demand | 19,430 | 17,115 |
| Remaining maturity | | |
| – three months or less | 26,112 | 25,525 |
| – one year or less but over three months | 11,902 | 8,357 |
| – five years or less but over one year | 266 | 422 |
| – over five years | 556 | 479 |
| | 58,266 | 51,898 |
| Specific bad and doubtful debt provisions | (6) | (7) |
| | 58,260 | 51,891 |
| Banking business | 22,354 | 21,358 |
| Trading business | 35,906 | 30,533 |



## **Notes on the accounts** continued

**12 Loans and advances to customers**

| | 2004 £m | 2003 £m |
|---|---|---|

| | | |
|---|---|---|
| On demand or short notice | 51,234 | 24,847 |
| Remaining maturity | | |
|  three months or less | 89,784 | 64,281 |
|  one year or less but over three months | 38,461 | 27,465 |
|  five years or less but over one year | 53,543 | 40,908 |
|  over five years | 116,669 | 98,952 |
| | 349,691 | 256,453 |
| General and specific bad and doubtful debt provisions | (4,222) | (3,922) |
| | 345,469 | 252,531 |
| Banking business | 283,233 | 223,456 |
| Trading business | 62,236 | 29,075 |
| Amounts above include: | | |
| Subordinated advances | 220 | 73 |
| Amounts receivable under finance leases | 9,968 | 8,405 |
| Amounts receivable under hire purchase and conditional sale agreements | 6,358 | 5,935 |

The cost of assets acquired during the year for the purpose of letting under finance leases and hire purchase agreements was £5,937 million (2003  £6,361 million).

The Groups exposure to risk from its lending activities is widely diversified both geographically and industrially. Lending to the services sector, house mortgage lending, loans to financial institutions, other personal loans and lending to property companies exceeded 10% of total loans and advances to customers (before provisions).

Residual value exposures
The table below gives details of the unguaranteed residual values included in the carrying value of finance lease receivables (see above) and operating lease assets (see Note 20).

| | Year in which the residual value will be recovered | | | | |
|---|---|---|---|---|---|
| 2004 | Within 1 year £m | After 1 year but within 2 years £m | After 2 years but within 5 years £m | After 5 years £m | Total £m |
| Operating leases | | | | | |
| Transportation | 69 | 387 | 1,260 | 2,603 | 4,319 |
| Cars and light commercial vehicles | 405 | 141 | 117 |  | 663 |
| Other | 14 | 19 | 65 | 11 | 109 |
| Finance leases | 34 | 33 | 70 | 355 | 492 |
| At 31 December 2004 | 522 | 580 | 1,512 | 2,969 | 5,583 |

| 2003 | Within 1 year £m | After 1 year but within 2 years £m | After 2 years but within 5 years £m | After 5 years £m | Total £m |
|---|---|---|---|---|---|
| | Year in which the residual value will be recovered | | | | |
| Operating leases | | | | | |
| Transportation | 548 | 198 | 481 | 2,344 | 3,571 |
| Cars and light commercial vehicles | 313 | 128 | 120 | — | 561 |
| Other | 11 | 21 | 54 | 96 | 182 |
| Finance leases | 62 | 21 | 85 | 158 | 326 |
| At 31 December 2003 | 934 | 368 | 740 | 2,598 | 4,640 |

*Linked presentation*

(i) Leveraged leases — as part of the purchase of Charter One, the Group acquired a portfolio of lease receivables that qualify as leveraged leases under US GAAP. Leveraged leases involve the Group as lessor obtaining non-recourse funding from third parties. This financing is secured on the underlying leases and the provider of the finance has no recourse whatsoever to the other assets of the Group. The Group is not obliged, and does not intend, to support losses that may be suffered by these third-party providers of funding. They have agreed in writing that they will be paid, as to interest and principal, only out of lease cash flows. At 31 December 2004, the gross value of leveraged leases amounted to £1,897 million and non-recourse financing received was £1,502 million. During the year the Group recognised net income of £13 million comprising interest receivable of £35 million less interest payable and other expenses of £22 million.

100

ii) Mortgage securitisations — following the acquisition of First Active in 2004, the Group is party to a number of mortgage securitisations that qualify for linked presentation. Mortgages have been transferred to special purpose vehicles, held ultimately by charitable trusts, funded principally through the issue of floating rate notes. The Group is not obliged, and does not intend, to support losses that may be suffered by the note holders. There are no arrangements for the Group to repurchase the mortgages. The note holders have agreed that they will be paid, as to interest and principal, only to the extent that sufficient funds are generated by the mortgage loans and their underlying security. The Group has entered into arm's length fixed/floating interest rate swaps with the securitisation vehicles and provides mortgage management and agency services to the vehicles. On repayment of the financing, any further amounts generated by the mortgages will be paid to the Group. At 31 December

2004, mortgages of £1,519 million are subject to non-recourse finance of £1,479 million. During the year the Group recognised net income of £26 million comprising interest receivable of £72 million less interest payable and other expenses of £46 million.

(iii) Securitisation of housing association loans – the Group has arranged the securitisation of housing association loans. The loans were acquired by special purpose vehicles, held ultimately by charitable trusts, funded principally through the issue of floating and fixed rate notes. The Group is not obliged, and does not intend, to support losses that may be suffered by the note holders. The note holders have agreed that they will be paid, as to interest and principal, only to the extent that sufficient funds are generated by the loans and their underlying security. Any proceeds from the loans in excess of the amounts required to service and repay the notes are payable to the Group after deduction of expenses. At 31 December 2004, gross loans amounted to £1,412 million (2003 – £1,450 million) and notes held by third parties were £1,012 million (2003 – £861 million).

During the year the Group recognised net income of £37 million (2003 – £39 million; 2002 – £40 million) comprising interest receivable of £116 million (2003 – £119 million; 2002 – £118 million) less interest payable and other expenses of £79 million (2003 – £80 million; 2002 – £78 million).

(iv) Mortgage banking activities - the Group sells originated mortgage loans to US Agencies in return for securities backed by these loans and guaranteed by the Agency whilst retaining the rights to service the mortgages. These securities may be subsequently sold. The purchaser has recourse to the Group for losses up to pre-determined levels on certain designated mortgages. The Group is not obliged, and does not intend, to support losses that may be suffered by the Agencies. Under the terms of the sale agreements, the Agencies have agreed to seek repayment only from the cash from the mortgage loans. Once the securities exchanged for the loans have been sold the Group's exposure is restricted to the amount of the recourse and the transaction qualifies for the linked presentation. At 31 December 2004 mortgages amounting to £472 million had been sold with recourse and the related securities sold. Recourse is limited to a maximum of £6 million. No amounts were recognised in the profit and loss account except for income from the servicing of the mortgages.

(v) Loan transfer – during 2004, loans originated by the Group and another bank were transferred to a special purpose vehicle which funded the purchase through the issue of notes. The Group is not obliged, and does not intend, to support losses that may be suffered by the note holders. There are no arrangements for the Group to repurchase the loan. The note holders have agreed that they will be paid, as to interest and principal, only to the extent that sufficient funds are generated by the loans. At 31 December 2004, the gross loan amounted to £301 million and the non-recourse financing of £301 million. Gross and net income in 2004 were less than £1 million.

## 13 Provisions for bad and doubtful debts

| | Specific £m | General £m | 2004 Total £m | Specific £m | General £m | 2003 Total £m |
|---|---|---|---|---|---|---|
| At 1 January | 3,363 | 566 | 3,929 | 3,330 | 597 | 3,927 |
| Currency translation and other adjustments | (22) | (76) | (98) | (23) | (39) | (62) |
| Acquisition of subsidiary | 222 | 68 | 290 | 44 | 6 | 50 |
| Amounts written off | (1,468) | – | (1,468) | (1,519) | – | (1,519) |
| Recoveries of amounts written off in previous periods | 147 | – | 147 | 72 | – | 72 |
| Charge to profit and loss account | 1,412 | 16 | 1,428 | 1,459 | 2 | 1,461 |

| | | | | | | |
|---|---|---|---|---|---|---|
| At 31 December | 3,654 | 574 | 4,228 | 3,363 | 566 | 3,929 |

## 14 Interest in suspense

In certain cases, interest may be charged to a customer's account but, because its recoverability is in doubt, not recognised in the Group's consolidated profit and loss account. Such interest is held in a suspense account and netted off against loans and advances in the consolidated balance sheet.

| | 2004 £m | 2003 £m |
|---|---|---|
| Loans and advances on which interest is being placed in suspense: | | |
| – before specific provisions | 2,558 | 1,938 |
| – after specific provisions | 1,203 | 930 |
| Loans and advances on which interest is not being applied: | | |
| – before specific provisions | 2,225 | 2,494 |
| – after specific provisions | 850 | 980 |



# **Notes on the accounts** continued

## 15 Debt securities

| | 2004 Book value £m | Gross unrecognised gains £m | Gross unrecognised losses £m | 2004 Valuation £m | 2003 Book value £m | Gross unrecognised gains £m |
|---|---|---|---|---|---|---|
| Investment securities: | | | | | | |
| UK government | 760 | 2 | (22) | 740 | 1,516 | 1 |
| Other government | 14,138 | 85 | (44) | 14,179 | 12,442 | 101 |
| Other public sector bodies | 309 | 1 | – | 310 | 422 | 4 |
| Bank and building society | 9,319 | 3 | (4) | 9,318 | 11,690 | 4 |
| Other issuers | 10,537 | 78 | (285) | 10,330 | 15,464 | 130 |
| | 35,063 | 169 | (355) | 34,877 | 41,534 | 240 |
| Other debt securities: | | | | | | |
| UK government | 1,502 | | | 1,502 | 1,246 | |
| Other government | 12,457 | | | 12,457 | 10,819 | |
| Other public sector bodies | 37 | | | 37 | 36 | |
| Bank and building society | 604 | | | 604 | 407 | |
| Other issuers | 41,548 | | | 41,548 | 25,907 | |

| | | | | | |
|---|---|---|---|---|---|
| | 56,148 | | | 56,148 | 38,415 |
| | 91,211 | | | 91,025 | 79,949 |
| Due within one year | 18,060 | | | | 16,943 |
| Due one year and over | 73,151 | | | | 63,006 |
| | 91,211 | | | | 79,949 |
| Investment securities: | | | | | |
| Listed | 25,201 | | | 25,198 | 33,067 |
| Unlisted | 9,862 | | | 9,679 | 8,467 |
| | 35,063 | | | 34,877 | 41,534 |
| Other debt securities: | | | | | |
| Listed | 28,714 | | | 28,714 | 16,307 |
| Unlisted | 27,434 | | | 27,434 | 22,108 |
| | 91,211 | | | 91,025 | 79,949 |
| Banking business | 36,485 | | | | 42,374 |
| Trading business | 54,726 | | | | 37,575 |
| Amounts above include: | | | | | |
| Subordinated debt securities | 664 | | | | 890 |
| Unamortised discounts less premiums on investment securities | 1 | | | | 3 |

The cost of securities carried at market value is not disclosed because it cannot be determined without unreasonable e

Movements in debt securities which are held as investment securities were as follows:

| | Cost £m | Discounts and premiums £m | Provisions £m | Book value £m |
|---|---|---|---|---|
| At 1 January 2004 | 41,440 | 216 | (122) | 41,534 |
| Currency translation and other adjustments | (1,610) | (18) | 2 | (1,626) |
| Additions | 41,217 | — | — | 41,217 |
| Acquisition of subsidiaries | 4,013 | (6) | — | 4,007 |
| Maturities and disposals | (42,529) | (48) | 10 | (42,567) |
| Provisions made net of write backs | — | — | (71) | (71) |
| Transfers to other debt securities | (7,429) | 6 | 1 | (7,422) |
| Amortisation of discounts and premiums | — | (9) | — | (9) |
| Amounts written off | (16) | — | 16 | — |

| | | | | |
|---|---|---|---|---|
| At 31 December 2004 | 35,086 | 141 | (164) | 35,063 |



The following table categorises the Group's investment debt securities by maturity and yield (based on weighted averages) at 31 December 2004:

| | Within 1 year | | After 1 but within 5 years | | After 5 but within 10 years | | After 10 years | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Amount £m | Yield % | Amount £m | Yield % | Amount £m | Yield % | Amount £m | Yield % | Amount £m | Yield % |
| UK government | 61 | 8.2 | 489 | 5.9 | 184 | 5.7 | 26 | 2.5 | 760 | 5.9 |
| US treasury and other US government | 254 | 1.4 | 326 | 2.2 | 944 | 2.6 | 11,185 | 3.0 | 12,709 | 3.0 |
| Other government | 442 | 1.7 | 617 | 3.9 | 314 | 3.8 | 4 | 5.7 | 1,377 | 3.2 |
| Securities issued by the states of the US | — | — | 18 | 4.9 | 16 | 4.1 | 18 | 3.4 | 52 | 4.1 |
| Other public sector bodies | 99 | 1.0 | 8 | 4.6 | 202 | 2.0 | — | — | 309 | 1.7 |
| Corporate debt securities | 750 | 3.5 | 982 | 3.8 | 227 | 4.0 | 224 | 4.9 | 2,183 | 3.8 |
| Mortgage-backed securities | 12 | 2.5 | 211 | 7.0 | 1,168 | 3.4 | 3,473 | 4.1 | 4,864 | 4.1 |
| Bank and building society | 8,158 | 5.2 | 1,089 | 3.4 | 44 | 5.0 | 28 | 5.3 | 9,319 | 5.0 |
| Other | 1,768 | 4.0 | 1,421 | 5.4 | 221 | 2.5 | 80 | 2.1 | 3,490 | 4.5 |
| Total book value | 11,544 | 4.6 | 5,161 | 4.4 | 3,320 | 3.2 | 15,038 | 3.3 | 35,063 | 3.9 |
| Total fair value | 11,297 | | 5,201 | | 3,288 | | 15,091 | | 34,877 | |

Gross gains of £101 million (2003 — £158 million) and gross losses of £30 million (2003 — £47 million) were realised on the sale and redemption of investment debt securities.

**16 Equity shares**

| | 2004 Book value £m | Gross unrecognised gains £m | Gross unrecognised losses £m | 2004 Valuation £m | 2003 Book value £m | Gross unrecognised gains £m | Gross unrecognised losses £m | 2003 Valuation £m |
|---|---|---|---|---|---|---|---|---|
| Investment securities: | | | | | | | | |
| Listed | 1,213 | 356 | (78) | 1,491 | 1,157 | 350 | (88) | 1,419 |
| Unlisted | 1,227 | 169 | (5) | 1,391 | 664 | 174 | (19) | 819 |
| | 2,440 | 525 | (83) | 2,882 | 1,821 | 524 | (107) | 2,238 |
| Other securities: | | | | | | | | |
| Listed | 519 | — | — | 519 | 465 | — | — | 465 |
| Unlisted | 1 | — | — | 1 | 14 | — | — | 14 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2,960 | 525 | (83) | 3,402 | 2,300 | 524 | (107) | 2,717 |
| Banking business | 2,474 | | | | 1,872 | | | |
| Trading business | 486 | | | | 428 | | | |

The cost of securities carried at market value is not disclosed because it cannot be determined without unreasonable expense.

Movements in equity shares which are held as investment securities were as follows:

| | Cost £m | Provisions £m | Book value £m |
|---|---|---|---|
| At 1 January 2004 | 1,940 | (119) | 1,821 |
| Currency translation and other adjustments | (61) | 5 | (56) |
| Additions | 573 | – | 573 |
| Acquisition of subsidiaries | 381 | – | 381 |
| Disposals | (288) | – | (288) |
| Amounts written off | (10) | 10 | – |
| Provisions made net of write backs | – | (12) | (12) |
| Transfers | 21 | – | 21 |
| At 31 December 2004 | 2,556 | (116) | 2,440 |

Gross gains of £96 million (2003 – £68 million) and gross losses of nil (2003 – £7 million) were realised on the sale of investment equity shares.



## **Notes on the accounts** continued

### 17 Shares in Group undertakings

Movements in shares in Group undertakings during the year were as follows:

| | £m |
|---|---|
| At 1 January 2004 | 32,354 |
| Currency translation adjustments | (399) |
| Additions | 6,802 |
| Revaluation | (1,887) |

| | |
|---|---|
| At 31 December 2004 | 36,870 |

On the historical cost basis, shares in Group undertakings at 31 December 2004 would have been included at a cost of £22,301 million (2003  £15,499 million).

The principal subsidiary undertakings of the company are shown below. Their capital consists of ordinary and preference shares which are unlisted with the exception of certain preference shares issued by NatWest. The Royal Bank and RBS Insurance Group Limited are directly owned by the company, and all of the other subsidiary undertakings are owned directly, or indirectly through intermediate holding companies, by these companies and are all wholly-owned. All of these subsidiaries are included in the Groups consolidated financial statements and have an accounting reference date of 31 December.

| | Nature of business | Country of incorporation and principal area of operation |
|---|---|---|
| The Royal Bank of Scotland plc | Banking | Great Britain |
| National Westminster Bank Plc (1) | Banking | Great Britain |
| Citizens Financial Group, Inc. | Banking | US |
| Coutts & Co (2) | Private banking | Great Britain |
| Greenwich Capital Markets, Inc. | Broker dealer | US |
| RBS Insurance Group Limited | Insurance | Great Britain |
| Ulster Bank Limited (3) | Banking | Northern Ireland |

Notes:

(1) The company does not hold any of the NatWest preference shares in issue.

(2) Coutts & Co is incorporated with unlimited liability. Its registered office is 440 Strand, London WC2R 0Q5.

(3) Ulster Bank Limited and its subsidiary undertakings also operate in the Republic of Ireland.

The above information is provided in relation to the principal related undertakings as permitted by Section 231(5) of the Companies Act 1985. Full information on all related undertakings will be included in the Annual Return filed with the UK Companies House.



## 18 Loans to Group undertakings

| Movements during the year: | £m |
|---|---|

| | |
|---|---|
| At 1 January 2004 | 4,554 |
| Currency translation and other adjustments | (216) |
| Additions | 350 |
| Repayments | (587) |
| At 31 December 2004 | 4,101 |

**19 Intangible fixed assets**

| Goodwill | £m |
|---|---|
| Cost: | |
| At 1 January 2004 | 15,758 |
| Currency translation and other adjustments | (558) |
| Arising on acquisitions during the year | 5,899 |
| Disposals | (20) |
| At 31 December 2004 | 21,079 |
| Amortisation: | |
| At 1 January 2004 | 2,627 |
| Currency translation and other adjustments | (35) |
| Charge for the year | 915 |
| Disposals | (4) |
| At 31 December 2004 | 3,503 |
| Net book value at 31 December 2004 | 17,576 |
| Net book value at 31 December 2003 | 13,131 |





**20 Tangible fixed assets**

| | Freehold premises £m | Long leasehold premises £m | Short leasehold premises £m | Computers and other equipment £m | Assets on operating leases £m | Total £m |
|---|---|---|---|---|---|---|
| Cost or valuation: | | | | | | |
| At 1 January 2004 | 5,217 | 1,346 | 655 | 2,911 | 7,548 | 17,677 |
| Currency translation and other adjustments | (18) | [illegible] | (10) | (41) | (185) | (254) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Reclassifications | 1 | (5) | (5) | 9 | — | — |
| Acquisition of subsidiaries | 152 | 32 | 41 | 133 | 487 | 845 |
| Additions | 589 | 21 | 212 | 691 | 2,841 | 4,354 |
| Disposals and write-off of fully depreciated assets | (302) | (21) | (48) | (136) | (1,352) | (1,859) |
| Revaluation adjustments | 16 | 2 | — | — | — | 18 |
| At 31 December 2004 | 5,655 | 1,375 | 845 | 3,567 | 9,339 | 20,781 |
| Consisting of: | | | | | | |
| At valuation – 2004 | 2,754 | 1,129 | — | — | — | 3,883 |
| – 2003 and prior | 821 | 134 | — | — | — | 955 |
| At cost | 2,080 | 112 | 845 | 3,567 | 9,339 | 15,943 |
| | 5,655 | 1,375 | 845 | 3,567 | 9,339 | 20,781 |
| Accumulated depreciation and amortisation: | | | | | | |
| At 1 January 2004 | 407 | 94 | 250 | 1,805 | 1,194 | 3,750 |
| Currency translation and other adjustments | (1) | 3 | (3) | (17) | (29) | (47) |
| Reclassifications | — | — | (2) | 2 | — | — |
| Acquisition of subsidiaries | — | 5 | — | 14 | 28 | 47 |
| Disposals and write-off of fully depreciated assets | (19) | (2) | (4) | (56) | (251) | (332) |
| Charge for the year | 60 | 11 | 42 | 355 | 639 | 1,107 |
| Revaluation adjustments | (19) | (19) | — | — | — | (38) |
| At 31 December 2004 | 428 | 92 | 283 | 2,103 | 1,581 | 4,487 |
| Net book value at 31 December 2004 | 5,227 | 1,283 | 562 | 1,464 | 7,758 | 16,294 |
| Net book value at 31 December 2003 | 4,810 | 1,252 | 405 | 1,106 | 6,354 | 13,927 |

On the historical cost basis, the Group's freehold and long leasehold premises would have been included at £6,249 million (2003 – £5,886 million).

Freehold and long leasehold properties are revalued on a rolling basis, each property being valued at least every five years. Interim valuations outwith the five year cycle are carried out on properties where there is an indication that their value has changed significantly, given market conditions. The directors are not aware of any material change in the valuation of the Group's properties and therefore no additional interim valuations were required.

Properties occupied by the Group are valued on the basis of Existing Use Value, except for certain specialised properties which are valued on a Depreciated Replacement Cost basis. Investment properties and properties to be disposed of are valued to reflect Open Market Value. Valuations are carried out by internal and external qualified surveyors who are members of the Royal Institution of Chartered Surveyors or, in the case of some overseas properties, locally qualified valuers.

| Net book value: | 2004 £m | 2003 £m |
|---|---|---|

| | | |
|---|---|---|
| Land and buildings occupied for own use | 2,768 | 2,391 |
| Investment properties | 3,715 | 3,628 |
| Properties under development | 570 | 429 |
| Properties to be disposed of | 19 | 19 |
| | 7,072 | 6,467 |
| Net book value of assets held under finance leases | 18 | 90 |
| Depreciation for the year of assets held under finance leases | 2 | 20 |
| Contracts for future capital expenditure not provided for in the accounts at the year end | | |
| Premises and equipment | 406 | 104 |
| Assets on operating leases | 196 | 498 |
| | 602 | 602 |

106

## 21 Other assets

| | 2004 £m | 2003* £m |
|---|---|---|
| Trading derivatives (see Note 39) | 17,884 | 14,087 |
| Other | 4,371 | 3,720 |
| | 22,255 | 17,807 |

*restated (see page 85)

## 22 Long-term assurance business

The long-term assurance assets and liabilities attributable to policyholders comprise:

| | 2004 £m | 2003 £m |
|---|---|---|
| Investments | 4,309 | 4,005 |
| Value of in-force policies | 418 | 413 |
| | 4,727 | 4,418 |

| | | |
|---|---|---|
| Long-term assurance business attributable to shareholders* | (927) | (861) |
| | 3,800 | 3,557 |

The increase in the shareholders interest in the long-term assurance business included in the profit and loss account is calculated as follows:

| | 2004 £m | 2003 £m |
|---|---|---|
| Increase in value for the year before tax | 94 | 73 |
| Tax | (28) | (22) |
| Increase in value for the year after tax | 66 | 51 |

* The value of the long-term assurance business is calculated by discounting estimated future flows of statutory profits from in-force business at a discount rate that includes a risk margin. The future flows are based on prudent assumptions about long-term economic and business experience determined with the advice of qualified actuaries. The risk margin is designed to reflect uncertainties in expected future flows.

The key assumptions used are:

| | 2004 % | 2003 % |
|---|---|---|
| Risk discount rate (net of tax) | 8.0 | 8.5 |
| Growth of unit-linked funds (gross of tax) | 6.9 | 6.7 |
| Growth of non-unit-linked funds (gross of tax) | 4.7 | 5.0 |
| Basic tax rate | 20.0 | 20.0 |
| Shareholder taxation  life | 30.0 | 30.0 |
| Expense inflation | 3.5 | 3.5 |

## 23 Deposits by banks

| | 2004 £m | 2003 £m |
|---|---|---|
| Repayable on demand | 30,279 | 20,995 |
| With agreed maturity dates or periods of notice, by remaining maturity | | |
|  three months or less | 53,296 | 42,300 |
|  one year or less but over three months | 10,474 | 2,268 |
|  five years or less but over one year | 3,675 | 122 |
|  over five years | 1,357 | 1,638 |
| | 99,081 | 67,323 |
| Banking business | 59,399 | 41,061 |
| Trading business | 39,682 | 26,262 |

## **Notes on the accounts** continued

### 24 Customer accounts

| | 2004 £m | 2003 £m |
|---|---|---|
| Repayable on demand | 193,988 | 160,574 |
| With agreed maturity dates or periods of notice, by remaining maturity | | |
| – three months or less | 66,542 | 64,797 |
| – one year or less but over three months | 15,502 | 7,608 |
| – five years or less but over one year | 7,803 | 3,288 |
| – over five years | 1,227 | 696 |
| | 285,062 | 236,963 |
| Banking business | 243,929 | 210,925 |
| Trading business | 41,133 | 26,038 |

### 25 Debt securities in issue

| | 2004 £m | 2003 £m |
|---|---|---|
| Bonds and medium term notes, by remaining maturity | | |
| – one year or less | 7,736 | 2,227 |
| – two years or less but over one year | 3,034 | 1,063 |
| – five years or less but over two years | 3,606 | 3,614 |
| – over five years | 1,328 | 3,525 |
| | 15,704 | 10,429 |
| Other debt securities in issue, by remaining maturity | | |
| – three months or less | 31,849 | 23,414 |
| – one year or less but over three months | 9,786 | 6,188 |
| – two years or less but over one year | 1,598 | 977 |
| – five years or less but over two years | 23 | 8 |
| | 43,256 | 30,587 |
| | 58,960 | 41,016 |
| Banking business | 57,200 | 39,899 |
| Trading business | 1,760 | 1,117 |

## 26 Settlement balances and short positions

| | 2004 £m | 2003 £m |
|---|---|---|
| Settlement balances | 4,067 | 2,241 |
| Short positions: | | |
| Debt securities – Government | 24,619 | 16,631 |
| – Other issuers | 4,002 | 2,423 |
| Treasury bills and other eligible bills | 302 | 74 |
| | 32,990 | 21,369 |

## 27 Other liabilities

| | 2004 £m | 2003 £m |
|---|---|---|
| Notes in circulation | 1,351 | 1,394 |
| Trading derivatives (see Note 39) | 19,034 | 15,173 |
| Current taxation | 677 | 700 |
| Dividends | 1,357 | 1,105 |
| Other liabilities | 3,733 | 2,212 |
| | 26,152 | 20,584 |



## 28 Deferred taxation

Provision for deferred taxation has been made as follows:

| | 2004 £m | 2003 £m |
|---|---|---|
| Deferred tax liability | 2,873 | 2,036 |
| Deferred tax asset (included in Note 21, Other assets) | (47) | (48) |
| Net deferred tax | 2,826 | 1,988 |

| | 2004 £m | 2003 £m |
|---|---|---|
| Short-term timing differences | (56) | (49) |
| Capital allowances | 3,248 | 2,440 |
| Bad and doubtful debt provisions | (399) | (441) |

| | | |
|---|---|---|
| Deferred gains | 33 | 38 |
| Net deferred tax | 2,826 | 1,988 |

| Movements during the year: | £m |
|---|---|
| As previously reported | 2,238 |
| Prior year adjustment arising on implementation of FRS 17 | (250) |
| At 1 January 2004 as restated | 1,988 |
| Currency translation and other adjustments | (66) |
| Acquisition of subsidiaries | 514 |
| Disposal of lease receivables | (43) |
| Charge to profit and loss account | 433 |
| At 31 December 2004 | 2,826 |

The deferred taxation balance at 31 December 2004 does not include any amounts in respect of the Group’s post-retirement benefit liabilities which is shown on the balance sheet after deduction of a deferred taxation asset of £995 million (2003 – £566 million)(see Note 3). The opening provision for deferred taxation has been restated following implementation of FRS 17 (see page 85).

**29 Other provisions**

| | Property(1) £m | Pensions and other similar obligations £m | Other(2) £m | Total £m |
|---|---|---|---|---|
| As previously reported | 179 | 43 | 34 | 256 |
| Prior year adjustment arising on implementation of FRS 17 | — | (43) | — | (43) |
| At 1 January 2004 as restated | 179 | — | 34 | 213 |
| Acquisition of subsidiaries | — | — | 12 | 12 |
| Charge to profit and loss account | 18 | — | 2 | 20 |
| Provisions utilised | (33) | — | (14) | (47) |
| At 31 December 2004 | 164 | — | 34 | 198 |

Notes:

(1) The Group has a number of leasehold properties where rents payable and other unavoidable costs exceed the value to the Group. Such costs arise over the period of the lease or to the expected termination date, and the provision has been discounted due to the long-term nature of certain of these obligations.

(2) Other provisions arise in the normal course of business.

## **Notes on the accounts** continued

### 30 Dated loan capital

| | 2004 £m | 2003 £m |
|---|---|---|
| The company | | |
| £200 million floating rate (minimum 5.25%) notes 2005 (1,2) | 40 | 80 |
| US$400 million 6.4% subordinated notes 2009 (1) | 206 | 223 |
| US$300 million 6.375% subordinated notes 2011 (1) | 154 | 166 |
| US$750 million 5% subordinated notes 2013 | 385 | 416 |
| US$750 million 5% subordinated notes 2014 (1) | 385 | 417 |
| US$250 million 5% subordinated notes 2014 (1) | 127 | 137 |
| US$675 million 5.05% subordinated notes 2015 (issued December 2004) (3) | 347 | — |
| US$350 million 4.7% subordinated notes 2018 (1) | 180 | 195 |
| | 1,824* | 1,634* |
| The Royal Bank of Scotland plc | | |
| £125 million subordinated floating rate notes 2005 (4) | 125 | 125 |
| £150 million 8.375% subordinated notes 2007 | 150 | 149 |
| DEM500 million (redesignated €255 million) 5.25% subordinated notes 2008 | 180 | 180 |
| €300 million 4.875% subordinated notes 2009 | 211 | 211 |
| US$150 million floating rate notes 2009 (5) | — | 84 |
| £35 million floating rate step-up subordinated notes 2010 | 35 | 35 |
| US$350 million floating rate subordinated notes 2012 | 181 | 196 |
| €130 million floating rate subordinated notes 2012 | 92 | 92 |
| US$500 million floating rate subordinated notes 2012 | 258 | 280 |
| £150 million 10.5% subordinated bonds 2013 (6) | 150 | 149 |
| €1,000 million 6.0% subordinated notes 2013 | 699 | 700 |
| €500 million 6.0% subordinated notes 2013 | 360 | 362 |
| US$50 million floating rate subordinated notes 2013 | 26 | 28 |
| €1,000 million floating rate subordinated notes 2013 (callable October 2008) | 704 | 705 |
| US$1,250 million floating rate subordinated notes 2014 (issued May 2004; callable July 2009) (7) | 646 | — |
| A$590 million 6.0% subordinated notes 2014 (issued October 2004; callable October 2009) (8) | 238 | — |
| A$410 million floating rate subordinated notes 2014 (issued October 2004; callable October 2009) (9) | 165 | — |
| £250 million 9.625% subordinated bonds 2015 | 248 | 248 |
| €750 million 4.875% subordinated notes 2015 | 528 | 529 |
| US$500 million floating rate subordinated notes 2016 (issued October 2004; callable October 2011) (10) | 258 | — |
| €500 million 4.5% subordinated notes 2016 (callable January 2011) | 351 | 351 |
| €100 million floating rate subordinated notes 2017 | 71 | 70 |
| US$125.6 million floating rate subordinated notes 2020 | 65 | 70 |
| €1,000 million 4.625% subordinated notes 2021 (issued September 2004; callable September 2016) (11) | 695 | — |
| RBSG Capital Corporation | | |
| US$250 million 10.125% guaranteed capital notes 2004 (12) | — | 140 |

| | | |
|---|---|---|
| National Westminster Bank Plc | | |
| £100 million 12.5% subordinated unsecured loan stock 2004 (13) | — | 104 |
| US$400 million guaranteed floating rate capital notes 2005 | 206 | 223 |
| US$1,000 million 7.375% subordinated notes 2009 | 513 | 553 |
| US$650 million floating rate subordinated step-up notes 2009 (14) | — | 366 |
| €600 million 6.0% subordinated notes 2010 | 420 | 419 |
| £300 million 8.125% step-up subordinated notes 2011 (callable December 2006) | 301 | 303 |
| €500 million 5.125% subordinated notes 2011 | 346 | 341 |
| £300 million 7.875% subordinated notes 2015 | 304 | 309 |
| £300 million 6.5% subordinated notes 2021 | 296 | 297 |
| Greenwich Capital Holdings, Inc. | | |
| US$105 million subordinated loan capital 2004 floating rate notes | — | 59 |
| US$105 million subordinated loan capital 2006 floating rate notes | 54 | — |
| Charter One Financial, Inc. (15) | | |
| US$400 million 6.375% subordinated notes 2012 | 226 | — |
| First Active plc (16) | | |
| US$35 million 7.24% subordinated bonds 2012 (callable December 2007) | 22 | — |
| £60 million 6.375% subordinated bonds 2018 (callable April 2013) | 65 | — |