ROYAL BANK OF SCOTLAND GROUP PLC
Form 20-F
April 26, 2006

As filed with the Securities and Exchange Commission on April 26, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

(Mark One)

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2005

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

o **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of event requiring this shell company report ___________
For the transition period from ___________ to ___________

Commission file number 0001-10306

THE ROYAL BANK OF SCOTLAND GROUP plc

(Exact name of Registrant as specified in its charter)

United Kingdom
(Jurisdiction of incorporation or organization)

RBS Gogarburn, PO Box 1000, Edinburgh EH12 1HQ
(Address of principal executive offices)

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

Title of each class	Name of each exchange on whic

American Depositary Shares Series D**, E, F, G, H, I**, K, L, M, N and P each representing one Non-Cumulative Dollar Preference Share, Series D, E, F, G, H, I, K, L, M, N and P, 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
** Redeemed on March 6, 2006
*** Redeemed on December 31, 2005

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 issuers classes of capital or common stock as of December 31, 2005, the close of the period covered by the annual report:

Ordinary shares of 25 pence each	3,196,543,671	Non-cumulative dollar preference shares, Series D to P	206,000,000
Non-voting Deferred Shares	2,660,556,304	Non-cumulative convertible dollar preference shares, Series 1	1,000,000
11% cumulative preference shares	500,000	Non-cumulative euro preference shares, Series 1 and 2	2,500,000
5½% cumulative preference shares	400,000		

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act

Yes x No o

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes o No x

Note checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

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

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x   Accelerated filer o   Non-accelerated filer o

Indicate by check mark which financial statement item the registrant has elected to follow.

o Item 17 x Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes o No o

SEC Form 20-F cross reference guide

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Operating and financial review

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Presentation of information

In the Form 20-F, 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.

International Financial Reporting Standards

As required by the Companies Act 1985 and Article 4 of the European Union IAS Regulation, the consolidated financial statements of the Group have been prepared, for the first time, in accordance with International Financial Reporting Standards adopted by the International Accounting Standards Board (IASB) and interpretations issued by the International Financial Reporting Interpretations Committee of the IASB (together “IFRS”) as endorsed by the European Union. The Group, however, has taken advantage of the option in IFRS 1 “First-time Adoption of International Financial Reporting Standards” to implement IAS 39 “Financial Instruments: Recognition and Measurement” (IAS 39), IAS 32 “Financial Instruments: Disclosure and Presentation” (IAS 32) and IFRS 4 “Insurance Contracts” (IFRS 4) from 1 January 2005 without restating its 2004 income statement and balance sheet. The implementation of IAS 32, IAS 39 and IFRS 4 on 1 January 2005 had a significant effect on the Group's balance sheet. To facilitate comparison, a balance sheet as at 1 January 2005 and a reconciliation of Shareholders’ funds as at 31 December 2004 are shown on pages 171 and 172 respectively. For a further discussion of the Group's adoption of IFRS, see “Accounting Policies–Adoption of International Financial Reporting Standards” on page 88.

The Group’s 2004 financial statements were prepared in accordance with then current UK generally accepted accounting principles (“UK GAAP” or “previous GAAP”) comprising standards issued by the UK Accounting Standards Board, pronouncements of the Urgent Issues Task Force, relevant Statements of Recommended Accounting Practice and provisions of the Companies Act 1985.

The Group also presents information under generally accepted accounting principles in the US (US GAAP).

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 worlds largest banking and financial services groups, with a market capitalisation of £56 billion at the end of 2005. Headquartered in Edinburgh, the Group operates in the UK, US and internationally through its two principal subsidiaries, the Royal Bank and NatWest, which are major UK clearing banks whose origins go back over 275 years. In the US, the Groups subsidiary Citizens Financial Group, Inc. (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 £776.8 billion and shareholders equity of £35.4 billion at 31 December 2005. It is strongly capitalised with a total capital ratio of 11.7% and tier 1 capital ratio of 7.6% as at 31 December 2005.

Organisational structure and business overview

The Groups activities are organised in the following business divisions: Corporate Markets (formerly Corporate Banking & Financial Markets), Retail Markets (comprising Retail Banking, Retail Direct and Wealth Management), Ulster Bank, Citizens, RBS Insurance and Manufacturing. A description of each of the divisions is given below.

Corporate Markets is focused on the provision of debt and risk management services to medium and large businesses and financial institutions in the UK and around the world. Corporate Banking & Financial Markets was renamed Corporate Markets on 1 January 2006 when its activities were reorganised into two businesses, UK Corporate Banking and Global Banking & Markets, in order to enhance our focus on the distinct needs of these two customer segments. These two divisions broadly correspond to the analysis of Corporate Markets by customer grouping presented in this review.

Corporate Markets provides an integrated range of core banking, structured finance and financial markets products and services, including acquisition finance, trade finance, leasing, factoring, treasury services, money markets, foreign exchange, derivatives, bond origination and trading, sovereign debt trading, futures brokerage and interest rate risk management services.

Corporate Markets is the largest provider of banking, finance and risk management services to Mid-Corporate and Commercial customers in the UK. Through its network of relationship managers across the country it provides the full range of Corporate Markets products and services to small, medium and large companies.

Corporate Markets is a leading banking partner to major corporations and financial institutions around the world, providing a full range of debt financing, risk management and investment services to its Global Banking & Markets customers.

Retail Markets was established in June 2005 to strengthen co-ordination and delivery of our multi-brand retail strategy. Retail Markets comprises Retail Banking, Retail Direct and Wealth Management.

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 and charge cards to personal and corporate customers and provides card processing services for retail businesses. It also includes Tesco Personal Finance, The One account, First Active UK, Direct Line Financial Services and Lombard Direct, all of which offer products to customers through direct channels principally in the UK. In continental Europe, Retail Direct offers a similar range of products through the RBS and Comfort Card brands.

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 20 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, principally in the Channel Islands, the Isle of Man and Gibraltar.

Ulster Bank brings together Ulster Bank and First Active to provide a highly effective challenger to the larger competitors in the Irish banking market. Serving personal and small business customers, Ulster Bank Retail Banking provides branch banking, wealth management and direct banking throughout the Republic of Ireland and Northern Ireland. With a continued focus on providing customer choice and value, First Active serves personal and small business customers through its separately branded product offerings and branch network throughout the Republic of Ireland. Both First Active and Ulster Bank retain their own brands, branch networks and distinctive customer propositions and benefits are achieved by selling more mortgage and savings products to Ulster Bank's customers and a broader range of banking products to First Active's customers.

Ulster Bank Corporate Banking & Financial Markets caters for the banking needs of business and corporate customers, including treasury and money market activities, asset finance, ebanking and international services.

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 Connecticut, Delaware, Massachusetts, New Hampshire, New Jersey, New York state, Pennsylvania, Rhode Island and Vermont and the Charter One brand in Illinois, Indiana, Michigan and Ohio. 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.

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 Direct Line brand, RBS Insurance also sells and underwrites personal insurance in Spain, Italy and Germany. Through UKI Partnerships, our partnership business, we operate insurance schemes on behalf of third parties who in turn sell insurance products to their customers. 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.

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.

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 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, specialist finance providers and, for smaller businesses, 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 the Group competes with UK banks and building societies. 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 the 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. Competitive activity is across a number of dimensions including introductory and longer term pricing, loyalty and reward schemes, and packaged benefits. Whilst competition remains intense, pricing of introductory interest rate offers has become less aggressive. In addition to physical distribution channels, providers compete through direct marketing activity and the internet.

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

private banks, and with international private banks.

RBS Insurance competes in personal lines insurance and to a limited extent in commercial insurance. There is strong 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 UK, Irish and other European institutions seek to expand their businesses.

In the United States, where competition is intense, 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 Group’s future results and cause them to be materially different from expected results. The Group’s results are also affected by competition and other factors. The factors discussed in this report should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties.

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 Group’s businesses. Adverse changes in the credit quality of the Group’s 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 Group’s assets and require an increase in the provision for impairment losses and other provisions.

Changes in interest rates, foreign exchange rates, equity prices and other market factors affect the Group’s 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 Group’s 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 Group’s 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 Group’s financial performance and business operations.

The Group’s insurance businesses are subject to inherent risks involving claims

Future claims in the Group’s 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 Group’s 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 Group’s business

The Group’s 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 Group’s 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 Group’s 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 and US, 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.

The risk of litigation is inherent in the Groups operations

In the ordinary course of the Groups business, legal actions, claims against and by the Group and arbitrations arise; the outcome of such legal proceedings could affect the financial performance of the Group.

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

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

As discussed on page 2, the consolidated financial statements of the Group have been prepared in accordance with International Financial Reporting Standards. The Group, however, has taken advantage of the option in IFRS 1 to implement IAS 32, IAS 39 and IFRS 4 from 1 January 2005 without restating its 2004 income statement and balance sheet. The implementation of IAS 32, IAS 39 and IFRS on 1 January 2005 had a significant effect on the Group's balance sheet. Therefore the income statements for 2005 and 2004 and the balance sheets at 31 December 2005 and 31 December 2004 discussed in the Operating and financial review are not directly comparable.

Financial highlights

for the year ended 31 December	2005 £m	2004 £m
Total income	25,902	23,391
Profit before tax	7,936	7,284
Profit attributable to ordinary shareholders	5,392	4,856
Cost:income ratio (%) (1)	46.1%	44.3%
Basic earnings per share (pence)	169.4	157.4
Return on equity (%) (2)	17.5%	18.3%

at 31 December	2005 £m	2004 £m	1 January 2005 £m
Total assets	776,827	588,122	696,510
Loans and advances to customers	417,226	347,251	381,162
Deposits	453,274	383,198	421,072
Shareholders equity	35,435	33,905	30,022
Risk asset ratio tier 1 (%)	7.6	7.0	6.7
total (%)	11.7	11.7	11.6

Notes:

(1) Cost:income ratio represents operating expenses expressed as a percentage of total income.

(2) Return on equity represents profit attributable to ordinary shareholders expressed as a percentage of average ordinary shareholders equity.

Operating and financial review continued

Summary consolidated income statement for the year ended 31 December 2005

	2005 £m	2004 £m
Net interest income	9,918	9,071
Fees and commissions receivable	6,750	6,473
Fees and commissions payable	(1,841)	(1,926)
Other non-interest income	5,296	4,126
Insurance premium income	6,076	6,146
Reinsurers share	(297)	(499)
Non-interest income	15,984	14,320
Total income	25,902	23,391
Operating expenses	11,946	10,362
Profit before other operating charges	13,956	13,029
Insurance claims	4,413	4,565
Reinsurers share	(100)	(305)
Operating profit before impairment losses	9,643	8,769
Impairment losses	1,707	1,485
Profit before tax	7,936	7,284
Tax on profit	2,378	1,995
Profit for the year	5,558	5,289
Minority interests	57	177
Preference dividends	109	256
Profit attributable to ordinary shareholders	5,392	4,856
Basic earnings per ordinary share	169.4p	157.4p

2005 compared with 2004

Profit

The implementation of IAS 32, IAS 39 and IFRS 4 on 1 January 2005 affected the timing of recognition of income and costs, classification of debt and equity, impairment provisions and accounting for insurance contracts in 2005.

Profit before tax was up 9%, from £7,284 million to £7,936 million. Strong underlying organic income growth in all divisions and a full year’s contribution from acquisitions made during 2004 were partially offset by the adverse impact on income of implementing IAS 32, IAS 39 and IFRS 4 on 1 January 2005.

Total income

Total income was up 11% or £2,511 million to £25,902 million. This reflected growth in all divisions particularly Corporate Markets, Citizens and Ulster Bank and also included gain of £333 million on sale of strategic investments. The effect of implementing the requirements of IAS 32, IAS 39 and IFRS 4 on 1 January 2005 was to reduce total income. Under IFRS, certain lending fees are deferred over the life of the financial asset and interest is recognised on a constant yield basis. The implementation of IAS 32 also resulted in most of the Group’s preference shares and minority interests being reclassified as debt and the interest thereon included in interest payable.

Net interest income increased by 9% to £9,918 million. Average loans and advances to customers and average customer deposits grew by 24% and 17% respectively. The effect of implementing the requirements of IAS 32, IAS 39 and IFRS 4 on 1 January 2005 was to reduce net interest income. Interest income is recognised on a constant yield basis under IFRS; under UK GAAP interest was recognised on an accrual basis. Interest payable also increased due to the reclassification of the Group’s preference shares and minority interests.

Non-interest income increased by 12% to £15,984 million with good growth in banking fee income, financial markets income and insurance premium income. Non-interest income represents 62% of total income. The effect of implementing the requirements of IAS 39 and IFRS 4 on 1 January 2005 was to reduce non-interest income, principally due to the deferral of certain lending fees.

Operating expenses

Operating expenses rose by 15% to £11,946 million, partly due to the implementation of IAS 39 and IFRS 4 on 1 January 2005. Operating expenses included loss on sale of subsidiaries of £93 million.

Integration

Integration costs were £458 million compared with £520 million in 2004. Included are software costs relating to the integration of NatWest which were written-off as incurred under UK GAAP but on transition to IFRS were capitalised and amortised. All such software is now fully amortised. The balance principally relates to the integration of Churchill, First Active and Citizens’ acquisitions, including Charter One which was acquired in August 2004.

Cost:income ratio

The Group’s cost:income ratio in 2005 was 46.1% (2004 – 44.3%), reflecting the impact on income in 2005 of IAS 32, IAS 39 and IFRS 4 and the first full year of acquisitions, particularly Charter One.

Net insurance claims

Bancassurance and general insurance claims after reinsurance, which under IFRS include maturities and surrenders, increased by 1% to £4,313 million.

Impairment losses

Impairment losses were £1,707 million compared with £1,485 million in 2004. Overall credit quality remained strong in 2005, with improvements in Corporate Markets partly offsetting

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Operating and financial review continued

higher impairment losses in Retail Markets. The effect of implementing the requirements of IAS 39 on 1 January 2005 was to increase loan impairment losses.

Risk elements in lending and potential problem loans represented 1.60% of gross loans and advances to customers excluding reverse repos at 31 December 2005 (31 December 2004 1.92%).

Provision coverage of risk elements in lending and potential problem loans was 65% compared with 72% at 31 December 2004. This reflects amounts written-off and the changing mix from unsecured to secured exposures.

Earnings and dividends

Basic earnings per ordinary share increased by 8% from 157.4p to 169.4p.

A final dividend of 53.1p per ordinary share, up 29% is recommended, giving a total dividend for the year of 72.5p, an increase of 25%. If approved, the final dividend will be paid on 9 June 2006 to shareholders registered on 10 March 2006.

Balance sheet

Total assets of £776.8 billion at 31 December 2005 were up £188.7 billion, 32%, compared with 31 December 2004, with £108.4 billion of this increase arising from the implementation of IAS 32, IAS 39 and IFRS 4 on 1 January 2005, and the balance reflecting business growth.

Loans and advances to customers were up £70.0 billion, 20%, at £417.2 billion of which £33.9 billion resulted from the implementation of IAS 32 and IAS 39, mainly as a result of the grossing up of previously netted customer balances. Excluding this and a decrease in reverse repos, down 24%, £15.7 billion to £48.9 billion, customer lending was up £51.8 billion, 16%, reflecting organic growth across all divisions.

Customer accounts were up £59.5 billion, 21% at £342.9 billion with £31.7 billion arising from the implementation of IAS 32 and IAS 39, largely reflecting the grossing up of previously netted deposits. Excluding this and repos, which decreased £5.7 billion, 11% to £48.8 billion, deposits rose by £33.5 billion, 13%, to £294.1 billion with good growth in all divisions.

Capital ratios at 31 December 2005 were 7.6% (Tier 1) and 11.7% (Total).

Profitability

The after-tax return on ordinary equity, which is based on profit attributable to ordinary shareholders and average ordinary equity was 17.5%.

Analysis of results

Net interest income

	2005 £m	2004 £m
Interest receivable	21,331	16,632
Interest payable	(11,413)	(7,561)
Net interest income	9,918	9,071
	%	%
Gross yield on interest-earning assets of the banking business	5.59	5.21
Cost of interest-bearing liabilities of the banking business	(3.36)	(2.70)
Interest spread of the banking business	2.23	2.51
Benefit from interest-free funds	0.37	0.33
Net interest margin of the banking business	2.60	2.84

Yields, spreads and margins of the banking business	%	%
Gross yield (1)		
Group	5.59	5.21
UK	6.06	5.58
Overseas	4.74	4.38
Interest spread (2)		
Group	2.23	2.51
UK	2.45	2.56
Overseas	1.87	2.48
Net interest margin (3)		
Group	2.60	2.84
UK	2.75	2.85
Overseas	2.32	2.83
The Royal Bank of Scotland plc base rate (average)	4.65	4.38
London inter-bank three month offered rates (average):		
Sterling	4.76	4.64
Eurodollar	3.56	1.62
Euro	2.18	2.11

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.

2005 compared with 2004

The net interest margin at 2.60% was down 24 basis points from 2.84% in 2004. The major contributors to the decline were product mix changes, driven by organic growth in lower margin mortgage lending and large corporate loans, and in rental assets as well as a change in deposit mix. The flattening of the US dollar yield curve also contributed to the reduction: the remainder was due to price re-positioning of some of our products. The implementation of IAS 32, IAS 39 and IFRS 4 on 1 January 2005 adversely impacted the net interest margin.

Operating and financial review continued

Average balance sheet and related interest

	2005			2004		
	Average balance £m	Interest £m	Rate %	Average balance £m	Interest £m	Rate %
Assets						
Treasury bills and other eligible bills UK	3,160	138	4.37	835	34	4.07
Overseas	55	2	3.64	62	1	1.61
Loans and advances to banks UK	15,477	649	4.19	13,696	529	3.86
Overseas	9,422	259	2.75	9,189	264	2.87
Loans and advances to customers UK	212,156	13,453	6.34	186,117	11,116	5.97
Overseas	104,579	5,206	4.98	69,118	3,201	4.63
Debt securities UK	14,731	630	4.28	21,859	726	3.32
Overseas	22,299	994	4.46	18,132	761	4.20
Total interest-earning assets banking business	381,879	21,331	5.59	319,008	16,632	5.21
trading business (2)	172,990			133,353		
Total interest-earning assets	554,869			452,361		
Non-interest-earning assets	182,179			70,446		
Total assets	737,048			522,807		
Percentage of assets applicable to overseas operations	35.3%			32.9%		
Liabilities and shareholders equity						
Deposits by banks UK	34,742	1,192	3.43	35,059	1,073	3.06
Overseas	27,383	891	3.25	16,425	398	2.42
Customer accounts: demand deposits UK	73,653	2,057	2.79	67,519	1,568	2.32
Overseas	13,823	299	2.16	11,580	147	1.27
Customer accounts: savings deposits UK	26,727	778	2.91	23,149	625	2.70
Overseas	21,700	381	1.76	18,349	252	1.37
Customer accounts: other time deposits UK	60,350	2,325	3.85	51,591	1,699	3.29
Overseas	32,024	979	3.06	20,725	479	2.31
Debt securities in issue UK	42,745	1,771	4.14	41,058	1,351	3.29
Overseas	19,621	633	3.23	12,320	229	1.86
Subordinated liabilities UK	23,948	1,117	4.66	17,959	665	3.70
Overseas	2,642	154	5.83	235	15	6.38

Internal funding of trading business UK	(37,628)	(1,125)	2.99	(35,317)	(920)	2.60
Overseas	(2,186)	(39)	1.78	(758)	(20)	2.64
Total interest-bearing liabilities banking business	339,544	11,413	3.36	279,894	7,561	2.70
trading business (2)	172,744			131,743		
Total interest-bearing liabilities	512,288			411,637		
Non-interest-bearing liabilities						
Demand deposits UK	17,484			17,157		
Overseas	11,181			9,101		
Other liabilities	163,147			53,827		
Shareholders equity	32,948			31,085		
Total liabilities and shareholders equity	737,048			522,807		
Percentage of liabilities applicable to overseas operations	33.5%			30.5%		

Notes:

(1) The analysis into UK and Overseas has been compiled on the basis of location of office.
(2) Interest receivable and interest payable on trading assets and liabilities are included in income from trading activities.
(3) Interest-earning assets and interest-bearing liabilities include the Retail bancassurance long-term assets and liabilities attributable to policyholders.
(4) Interest income and interest expense do not include interest on financial assets and liabilities designated as at fair value through profit or loss. Interest-earning assets and interest-bearing liabilities do not include the related balances.

Operating and financial review continued

Analysis of change in net interest income volume and rate analysis

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

	2005 over 2004		
	Increase/(decrease) due to changes in:		
	Average volume £m	Average rate £m	Net change £m
Interest- earning assets			
Treasury bills and other eligible bills			
UK	101	3	104
Overseas	-	1	1
Loans and advances to banks			
UK	72	48	120
Overseas	6	(11)	(5)
Loans and advances to customers			
UK	1,620	717	2,337
Overseas	1,748	257	2,005
Debt securities			
UK	(273)	177	(96)
Overseas	184	49	233
Total interest receivable of the banking business			
UK	1,520	945	2,465
Overseas	1,938	296	2,234
	3,458	1,241	4,699
Interest-bearing liabilities			
Deposits by banks			
UK	10	(129)	(119)
Overseas	(326)	(167)	(493)
Customer accounts: demand deposits			
UK	(151)	(338)	(489)
Overseas	(33)	(119)	(152)
Customer accounts: savings deposits			
UK	(102)	(51)	(153)
Overseas	(50)	(79)	(129)
Customer accounts: other time deposits			
UK	(313)	(313)	(626)
Overseas	(313)	(187)	(500)
Debt securities in issue			

UK	(58)	(362)	(420)
Overseas	(180)	(224)	(404)
Subordinated liabilities			
UK	(254)	(198)	(452)
Overseas	(140)	1	(139)
Internal funding of trading business			
UK	62	143	205
Overseas	27	(8)	19
Total interest payable of the banking business			
UK	(806)	(1,248)	(2,054)
Overseas	(1,015)	(783)	(1,798)
	(1,821)	(2,031)	(3,852)
Movement in net interest income			
UK	714	(303)	411
Overseas	923	(487)	436
	1,637	(790)	847

Operating and financial review continued

Analysis of results

Net interest income

As discussed on page 2, the Group implemented IFRS with effect from 1 January 2004. The average balance sheet and related data presented for 2003 on pages 14 to 16 are based on UK GAAP and therefore not directly comparable with the average balance sheet and related data for 2004 or 2005, each of which is based on IFRS. For a more complete discussion of the Groups adoption of IFRS, see Accounting PoliciesAdoption of International Financial Reporting Standards on page 88.

	2003 - UK GAAP £m
Interest receivable	13,998
Interest payable	(5,697)
Net interest income	8,301

	%
Gross yield on interest-earning assets of the banking business	5.00
Cost of interest-bearing liabilities of the banking business	(2.32)
Interest spread of the banking business	2.68
Benefit from interest-free funds	0.29
Net interest margin of the banking business	2.97

Yields, spreads and margins of the banking business	%
Gross yield (1)	
Group	5.00
UK	5.20
Overseas	4.44
Interest spread (2)	
Group	2.68
UK	2.68
Overseas	2.71
Net interest margin (3)	
Group	2.97
UK	2.95
Overseas	3.02
The Royal Bank of Scotland plc base rate (average)	3.69
London inter-bank three month offered rates (average):	

Sterling	3.74
Eurodollar	1.22
Euro	2.33

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.

Average balance sheet and related interest

	2003 - UK GAAP		
	Average balance £m	Interest £m	Rate %
Assets			
Treasury bills and other eligible bills UK	1,378	48	3.48
Overseas	64	1	1.56
Loans and advances to banks UK	13,724	459	3.34
Overseas	9,559	212	2.22
Loans and advances to customers UK	168,390	9,519	5.65
Overseas	44,862	2,240	4.99
Debt securities UK	23,810	754	3.17
Overseas	17,927	765	4.27
Total interest-earning assets banking business	279,714	13,998	5.00
trading business (2)	96,648		
Total interest-earning assets	376,362		
Non-interest-earning assets	66,060		
Total assets	442,422		
Percentage of assets applicable to overseas operations	32.4%		
Liabilities and shareholders equity			
Deposits by banks UK	28,220	703	2.49
Overseas	9,565	218	2.28
Customer accounts: demand deposits UK	64,469	1,028	1.59
Overseas	9,166	70	0.76
Customer accounts: savings deposits UK	18,653	503	2.70
Overseas	16,310	260	1.59
Customer accounts: other time deposits UK	49,880	1,478	2.96
Overseas	16,642	374	2.25
Debt securities in issue UK	29,977	914	3.05
Overseas	9,630	119	1.24
Subordinated liabilities UK	15,342	534	3.48
Overseas	154	16	10.39

Internal funding of trading business UK	(21,258)	(497)	2.34
Overseas	(1,651)	(23)	1.39
Total interest-bearing liabilities banking business	245,099	5,697	2.32
Total interest-bearing liabilities trading business (2)	93,466		
Total interest-bearing liabilities	338,565		
Non-interest-bearing liabilities			
Demand deposits UK	17,589		
Overseas	7,330		
Other liabilities	52,810		
Shareholders funds	26,128		
Total liabilities and shareholders equity	442,422		
Percentage of liabilities applicable to overseas operations	30.6%		

Notes:

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

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

Operating and financial review continued

Analysis of change in net interest income volume and rate analysis

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

	2004 over 2003		
	Increase/(decrease) due to changes in:		
	Average volume £m	Average rate £m	Net change £m
Interest- earning assets			
Treasury bills and other eligible bills			
UK	(21)	7	(14)
Overseas	-	-	-
Loans and advances to banks			
UK	(1)	71	70
Overseas	(8)	60	52
Loans and advances to customers			
UK	1,038	559	1,597
Overseas	1,133	(172)	961
Debt securities			
UK	(63)	35	(28)
Overseas	9	(13)	(4)
Total interest receivable of the banking business			
UK	953	672	1,625
Overseas	1,134	(125)	1,009
	2,087	547	2,634
Interest-bearing liabilities			
Deposits by banks			
UK	(190)	(180)	(370)
Overseas	(166)	(14)	(180)
Customer accounts: demand deposits			
UK	(50)	(490)	(540)
Overseas	(22)	(55)	(77)
Customer accounts: savings deposits			
UK	(122)	-	(122)
Overseas	(30)	38	8
Customer accounts: other time deposits			
UK	(52)	(169)	(221)
Overseas	(95)	(10)	(105)
Debt securities in issue			

UK	(360)	(77)	(437)
Overseas	(39)	(71)	(110)
Subordinated liabilities			
UK	(96)	(35)	(131)
Overseas	(7)	8	1
Internal funding of trading business			
UK	362	61	423
Overseas	(17)	14	(3)
Total interest payable of the banking business			
UK	(508)	(890)	(1,398)
Overseas	(376)	(90)	(466)
	(884)	(980)	(1,864)
Movement in net interest income			
UK	445	(218)	227
Overseas	758	(215)	543
	1,203	(433)	770

Non-interest income

	2005 £m	2004 £m
Fees and commissions receivable	6,750	6,473
Fees and commissions payable	(1,841)	(1,926)
Income from trading activities	2,343	1,988
Other operating income	2,953	2,138
	10,205	8,673
Insurance premium income	6,076	6,146
Reinsurers share	(297)	(499)
	5,779	5,647
	15,984	14,320

2005 compared with 2004

Non-interest income increased by £1,664 million, 12% to £15,984 million reflecting strong performances in Corporate Markets and Citizens, and good growth in banking fee income, financial markets income and insurance premium income. The effect of implementing IAS 39 and IFRS 4 on 1 January 2005 was to reduce non-interest income.

Within non-interest income, fees and commissions receivable increased by 4% or £277 million, to £6,750 million, while fees and commissions payable decreased by £85 million to £1,841 million. Under IFRS, certain lending fees are deferred over the life of the financial asset.

Income from trading activities, which primarily arises from providing customers with debt and risk management products in interest rate, currency and credit, was up £355 million, 18%. The increase on 2004 reflected higher customer volumes.

Other operating income increased by 38%, £815 million to £2,953 million. This was principally due to higher income from rental assets, increased bancassurance income, realised investment securities gains and the gain on sale of strategic investments.

General insurance premium income, after reinsurance, rose by 2%, or £132 million to £5,779 million reflecting volume growth in motor and home insurance products.

Operating and financial review continued

Operating expenses

	2005 £m	2004 £m
Administrative expenses:		
Staff costs	5,992	5,188
Premises and equipment	1,313	1,177
Other administrative expenses	2,816	2,323
Total administrative expenses	10,121	8,688
Depreciation and amortisation	1,825	1,674
	11,946	10,362

2005 compared with 2004

Operating expenses rose by 15% to £11,946 million to support growth in business volumes and included the loss on sale of subsidiaries.

Staff costs were up £804 million, 15% to £5,922 million reflecting business growth. The number of staff increased by 400 to 137,000.

Premises and equipment expenses increased by £136 million, 12% to £1,313 million reflecting our programme of investment both in the branch networks and in our major operational centres.

Other administrative expenses, up 21%, £493 million reflected business volume growth and ongoing expenditure on regulatory projects.

The Groups ratio of operating expenses to total income was 46.1% compared with 44.3% in 2004, partly due to the full year effect of acquisitions and the impact of implementing IAS 32, IAS 39 and IFRS 4 on 1 January 2005.

Integration costs

	2005 £m	2004 £m
Staff costs	148	83
Premises and equipment	39	35
Other administrative expenses	131	149
Depreciation and amortisation	140	253
	458	520

Integration costs were £458 million compared with £520 million in 2004 comprising amortisation of internally developed software and other expenditure. Software costs were previously written off as incurred under UK GAAP but under IFRS are now amortised over 3-5 years. All software relating to the NatWest integration was fully amortised by the end of 2005. The balance of integration costs principally relates to the integration of Churchill, First Active and Citizens acquisitions, including Charter One which was acquired in August 2004.

Accruals in relation to integration costs are set out below.

	At 31 December 2004 £m	Currency translation adjustments £m	Charge to income statement £m	Utilised during the year £m	At 31 December 2005 £m
Staff costs redundancy	11	1	23	(18)	17
Staff costs other	29	1	125	(140)	15
Premises and equipment	13	2	39	(40)	14
Other	44	2	271	(291)	26
	97	6	458	(489)	72

Operating and financial review continued

Impairment losses

IAS 39 impacted the way in which loan impairment losses are calculated and was implemented on 1 January 2005 without restatement of comparatives. Consequently, the data in the following tables for 2005 and 2004 are not directly comparable.

	2005 £m	2004 £m
New impairment losses	1,879	1,629
less: recoveries of amounts previously written-off	(172)	(144)
Charge to income statement	1,707	1,485
Comprising:		
Loan impairment losses	1,703	1,402
Other impairment losses	4	83
Charge to income statement	1,707	1,485

2005 compared with 2004

Impairment losses were £1,707 million compared with £1,485 million in 2004 with higher provisions in Retail Markets partly offset by improvements in Corporate Markets. Following the implementation of IAS 39 on 1 January 2005, loan impairment losses are based on the discounted value of expected recoveries. As a result, provisions are higher initially but the difference between the discounted and undiscounted amounts emerges as interest income over the recovery period.

New impairment losses were up 15%, £250 million to £1,879 million. Recoveries of amounts previously written off were up £28 million, 19% to £172 million. Consequently the net charge to the income statement was up £222 million, 15% to £1,707 million.

Total balance sheet provisions for impairment amounted to £3,887 million compared with £4,174 million at 31 December 2004. Total provision coverage (the ratio of total balance sheet provisions for impairment to total risk elements in lending) decreased from 76% to 65%.

The ratio of total balance sheet provisions for impairment to total risk elements in lending and potential problem loans decreased to 65% compared with 72% at 31 December 2004. This reflects amounts written-off and the changing mix from unsecured to secured exposure.

Other impairment losses were £4 million compared with £83 million in 2004.

Taxation

	2005 £m	2004 £m
Tax	2,378	1,995
	%	%

UK corporation tax rate	30.0	30.0
Effective tax rate	30.0	27.4

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

	2005 £m	2004 £m
Expected tax charge	2,381	2,185
Interest on subordinated debt not allowable for tax	79	–
Non-deductible items	230	110
Non-taxable items	(166)	(128)
Taxable foreign exchange movements	(10)	(10)
Foreign profits taxed at other rates	77	49
Unutilised losses – brought forward and carried forward	(5)	6
Adjustments in respect of prior periods	(208)	(217)
Actual tax charge	2,378	1,995

Divisional performance

The contribution of each division before amortisation of purchased intangible assets, integration costs and net gain on sale of strategic investments and subsidiaries and, where appropriate, Manufacturing costs is detailed below.

	2005 £m	2004 £m
Corporate Markets	5,224	4,226
Retail Markets		
Retail Banking	3,009	3,212
Retail Direct	790	885
Wealth Management	408	357
Total Retail Markets	4,207	4,454
Ulster Bank	530	452
Citizens	1,575	1,071
RBS Insurance	926	863
Manufacturing	(2,743)	(2,552)
Central items	(1,468)	(665)
Profit before amortisation of purchased intangible assets, integration costs and net gain on sale of strategic investments and subsidiaries	8,251	7,849
Amortisation of purchased intangible assets	97	45
Integration costs	458	520
Net gain on sale of strategic investments and subsidiaries	240	–
Profit before tax	7,936	7,284

The performance of each of the divisions is reviewed on pages 22 to 33.

Operating and financial review continued

Corporate Markets

	2005 £m	2004 £m
Net interest income	2,960	2,561
Non-interest income	5,855	5,090
Total income	8,815	7,651
Direct expenses		
staff costs	2,000	1,705
other	523	459
operating lease depreciation	733	680
	3,256	2,844
Contribution before impairment losses	5,559	4,807
Impairment losses	335	581
Contribution	5,224	4,226

	31 December 2005 £bn	1 January 2005 £bn
Total assets*	409.2	359.4
Loans and advances to customers gross*		
banking book	158.7	136.9
trading book	11.8	10.1
Rental assets	13.2	11.5
Customer deposits*	111.1	100.8
Weighted risk assets	202.6	178.4

* excluding repos and reverse repos

Corporate Markets achieved excellent results in 2005, with total income up 15% to £8,815 million and contribution up 24% to £5,224 million, reflecting very good performances across our businesses.

RBS remains the number 1 corporate bank in the UK and we have significantly expanded our franchise in Europe and North America, where we are also focussing on the opportunities for increased co-operation between Corporate Markets and Citizens. In Asia, our profile has benefited from the announcement of the Groups strategic partnership with Bank of China.

Our businesses continue to deliver good returns. Weighted risk assets rose by 14% over the course of the year to £202.6 billion, with much slower growth in the second half following the above-trend spike at 30 June 2005. The ratio of income to average weighted risk assets for 2005 was broadly stable, while the ratio of contribution to

average weighted risk assets improved slightly.

Corporate Markets Mid-Corporate and Commercial

	2005 £m	2004 £m
Net interest income	1,760	1,477
Non-interest income	1,257	1,333
Total income	3,017	2,810
Direct expenses		
staff costs	529	489
other	132	123
operating lease depreciation	335	322
	996	934
Contribution before impairment losses	2,021	1,876
Impairment losses	218	270
Contribution	1,803	1,606

	31 December 2005 £bn	1 January 2005 £bn
Total assets*	70.4	61.6
Loans and advances to customers gross*	67.9	59.4
Customer deposits*	60.0	51.8
Weighted risk assets	74.2	65.6

* excluding repos and reverse repos

Corporate Markets generated good results in the Mid-Corporate & Commercial customer segment in 2005, building on the strength of its UK franchise. We maintained our market-leading positions in corporate and commercial banking, asset finance and invoice finance. Total income rose by 7% to £3,017 million, whilst contribution rose by 12% to £1,803 million.

Net interest income increased 19% to £1,760 million as a result of strong growth in average lending and in average customer deposits.

Non-interest income declined by 6% to £1,257 million, reflecting the effect of IAS 39 on recognition of fee income being partially offset by our continued success in cross-selling our full range of products and services to customers. Our business has benefited from the co-location of our asset finance and invoice finance managers with our corporate and commercial banking operations.

Expense growth was 7% which included a further investment in customer-facing staff.

Impairment losses were 19% lower than in 2004 at £218 million, reflecting a further improvement in our credit metrics.

Operating and financial review continued

Corporate Markets Global Banking & Markets

	2005 £m	2004 £m
Net interest income excluding funding cost of rental assets	1,652	1,454
Funding cost of rental assets	(452)	(370)
Net interest income	1,200	1,084
Fees and commissions receivable	1,060	969
Fees and commissions payable	(252)	(217)
Income from trading activities	1,964	1,751
Income on rental assets	1,074	924
Other operating income	752	330
Non-interest income	4,598	3,757
Total income	5,798	4,841
Direct expenses		
staff costs	1,471	1,216
other	391	336
operating lease depreciation	398	358
	2,260	1,910
Contribution before impairment losses	3,538	2,931
Impairment losses	117	311
Contribution	3,421	2,620

	31 December 2005 £bn	1 January 2005 £bn
Total assets*	338.8	297.8
Loans and advances to customers gross*		
banking book	90.8	77.5
trading book	11.8	10.1
Rental assets	11.9	10.3
Customer deposits*	51.1	49.0
Weighted risk assets	128.4	112.8

* excluding repos and reverse repos

An excellent performance from our Global Banking & Markets customer segment in 2005 shows the fruits of the global platform we have built over the last five years, with good growth in all major geographies and across-the-board success in income generation from our core banking, structured finance and financial markets activities.

Total income rose by 20% to £5,798 million, with contribution up 31% to £3,421 million, benefiting from cost discipline and continuing benign credit conditions.

Debt underwriting volumes remained strong throughout the course of the year, reflecting our involvement in many of the largest financings in the UK and Europe for both large corporates and private equity sponsors. We were the fourth most active bank worldwide in arranging and underwriting bank lending in 2005. A strong distribution performance brought weighted risk assets to £128.4 billion at year-end, up 14% over the year and back to a more consistent trend level than the amount at 30 June 2005.

Non-interest income grew by 22% to £4,598 million and now accounts for 79% of Global Banking & Markets revenues.

We recorded good growth in fees earned from customer services in risk management, financial structuring and debt-raising. A strong performance from RBS Greenwich Capital, which has been brought together with other Corporate Markets activities in North America, contributed to steady growth in income from trading activities. Customer volumes were higher across all products and particularly good in our credit markets businesses. Average trading Value at Risk was held steady at a very conservative level, £12 million.

Our continuing success in aircraft, train, ship and hotel leasing delivered good growth in net income from rental assets. Other operating income grew strongly, with our structured finance investment portfolio producing good realised gains, notably in the second half of the year.

Growth in expenses was 18%, reflecting variable performance-related costs.

Retail Markets

Retail Markets was established in June 2005 to strengthen co-ordination and delivery of our multi-brand retail strategy across our product range, and comprises Retail Banking, Retail Direct and Wealth Management. The performance of each of these divisions is discussed on pages 26, 27 and 28, respectively.

	2005 £m	2004 £m
Net interest income	4,499	4,261
Non-interest income	3,714	3,869
Total income	8,213	8,130
Direct expenses		
– staff costs	1,514	1,446
– other	821	808
	2,335	2,254
Insurance net claims	486	702
Contribution before impairment losses	5,392	5,174
Impairment losses	1,185	720
Contribution	4,207	4,454

	31 December 2005 £bn	1 January 2005 £bn
Total banking assets	114.4	104.9
Loans and advances to customers		
– mortgages	64.6	56.9
– personal	21.5	20.2
– cards	9.6	9.4
– business	16.7	15.9
Customer deposits	105.9	97.0
Investment management assets – excluding deposits	31.4	26.6
Weighted risk assets	80.6	76.5

Total income increased by 1% to £8,213 million and contribution decreased by 6% to £4,207 million, with good discipline on costs helping to partially offset increased impairment losses on unsecured lending.

At the end of 2004 we referred to the changes being seen in the retail markets with the consumer transitioning from an environment which had seen several years of very fast growth in consumer lending to an increased emphasis on savings and investment.

As a consequence, we planned to refocus our strategy to grow our sales of deposit and bancassurance products faster than the market, to exploit our potential for building profitable market share in the mortgage market and to concentrate more on the development of our branch franchise, building on our strong service proposition. During 2005 this transition has gathered momentum and we have achieved good progress in our strategies.

Branch deposit balances outgrew the market and our bancassurance sales accelerated strongly, with annual premium equivalent sales 25% higher than in 2004. Our share of net mortgage lending, assisted by the launch of the First Active brand, reached 8% in 2005. Our credit card business, meanwhile, made excellent headway in marketing through branch channels; we gained 60% more credit card customers in our core NatWest and RBS brands in the second half than in the same period of 2004.

Operating and financial review continued

Retail Banking

	2005 £m	2004 £m
Net interest income	3,175	3,076
Non-interest income	2,258	2,504
Total income	5,433	5,580
Direct expenses		
staff costs	1,026	964
other	311	313
	1,337	1,277
Insurance net claims	486	702
Contribution before impairment losses	3,610	3,601
Impairment losses	601	389
Contribution	3,009	3,212

	31 December 2005 £bn	1 January 2005 £bn
Total banking assets	77.1	72.8
Loans and advances to customers gross		
mortgages	47.3	44.1
personal	13.7	13.2
business	16.3	15.3
Customer deposits	77.7	71.9
Weighted risk assets	54.0	51.1

Retail Banking total income for 2005 of £5,433 million and contribution of £3,009 million were adversely affected by the implementation of IAS 32, IAS 39 and IFRS 4 on 1 January 2005. Contribution before impairment losses increased to £3,610 million.

Overall customer numbers have increased since December 2004 with personal customers up 274,000 (2%) and registered internet customers up 30%. During 2005 we continued to demonstrate our commitment to customer service, with significant progress in terms of the proportion of our customers who are extremely satisfied and we are making pleasing progress in the current account switcher market. Among the high street banks, Royal Bank of Scotland ranks first for customer satisfaction with NatWest now in joint second place. NatWest remains the number one bank for students. In 2005, 44% of first year students in England and Wales chose to open new accounts with us compared with 42% in 2004.

Against the backdrop of a slower rate of growth in consumer borrowing, we have delivered robust business growth in average loans and advances, especially mortgage lending with particularly good growth in higher margin products such as the offset mortgage. Average unsecured personal lending, where we took further steps to enhance our focus on high quality new business, was also up. Average customer deposits grew, with particularly good inflows into savings products.

Net interest income was £3,175 million. Net interest margin was lower in 2005 than in 2004 with increased product margins offsetting mix effects. Spreads in mortgages and some savings products improved in the latter part of the year.

Non-interest income fell by 10% to £2,258 million. Growth in income from core personal and small business banking services, and good progress in our private banking and investment businesses were more than offset by the affect of IAS 39 and IFRS 4 on recognition of fee income and bancassurance income.

Direct expense grew by 5%, partly due to investment in future income initiatives in the second half. Staff costs increased by 6% to £1,026 million as a result of continued investment in customer-facing staff with over 500 additional customer advisors in branches, an increase in telephone banking advisors, and continued expansion of our bancassurance and investment businesses. We continue to make efficiency gains in other areas resulting in a decrease in other costs to £311 million.

Net claims in bancassurance, which under IFRS include maturities, surrenders and liabilities to policyholders, were £486 million compared with £702 million in 2004.

Impairment losses increased by 54% or £212 million to £601 million. The increased charge principally reflects the implementation of IAS 39 from 1 January 2005 and the growth in lending over recent years, including 17% growth in 2004. We have taken further steps to refine our credit policy and improved our recoveries process. Mortgage arrears remain very low. The average loan-to-value ratio on new mortgages written in 2005 was 62% and on the stock of mortgages was 46%. Small business credit quality remains stable.

Retail Direct

	2005 £m	2004 £m
Net interest income	882	782
Non-interest income	1,084	995
Total income	1,966	1,777
Direct expenses		
staff costs	230	220
other	375	359
	605	579
Contribution before impairment losses	1,361	1,198
Impairment losses	571	313
Contribution	790	885

	31 December 2005 £bn	1 January 2005 £bn
Total assets	27.2	23.0
Loans and advances to customers gross		
mortgages	13.8	9.4
cards	9.5	9.3
other	4.0	3.8
Customer deposits	2.7	2.8
Weighted risk assets	20.5	19.4

Total income rose by 11% to £1,966 million and contribution before impairment losses by 14% to £1,361 million, a strong performance in the context of slower growth in demand for unsecured credit. This performance reflected disciplined pricing, tight cost control and stringent credit assessment. Contribution after impairment losses decreased by 11% to £790 million.

During the year, the number of customer accounts increased by 734,000, 4%. In the light of changing market conditions we have focussed our marketing efforts on existing customers, and this has resulted in very strong growth in our core NatWest and RBS brands. We gained 336,000 credit card accounts in these brands in the second half of 2005, 60% more than in the equivalent period of 2004.

Net interest income increased by 13% to £882 million, reflecting the success of the First Active brand in the UK mortgage market and the maturing of the MINT portfolio. Average loans and advances rose strongly with the fastest growth coming in mortgages. Personal loan growth slowed, reflecting strategic decisions taken over the last 18 months to reposition pricing and tighten lending criteria for personal loans sold directly.

Net interest margin was only slightly lower than in 2004, as wider margins on our cards portfolio balanced the effects of the increasing weight of mortgage assets in our loan book.

Non-interest income was up 9% to £1,084 million, benefiting from higher volumes in both domestic and international card acquiring, strong sales through Tesco Personal Finance, the introduction of balance transfer fees and good growth in Europe.

Expenses increased by 4% to £605 million, with stringent cost control across all activities, including reduced marketing costs on personal loans. This was consistent with our more cautious approach to direct lending and with our successful focus on recruitment of customers through branches.

Impairment losses rose by 82% to £571 million, reflecting higher lending volumes, the increase in personal arrears signalled at the end of 2004 and the effect of implementing IAS 39 from 1 January 2005. There are some signs of a stabilisation of credit quality, assisted by the tightening of lending criteria. Mortgage arrears remain very low. The average loan-to-value ratio on new mortgages written in 2005 was 51% and on the stock of mortgages was 44%.

Operating and financial review continued

Wealth Management

	2005 £m	2004 £m
Net interest income	442	403
Non-interest income	372	370
Total income	814	773
Expenses		
staff costs	258	262
other	135	136
	393	398
Contribution before impairment losses	421	375
Impairment losses	13	18
Contribution	408	357

	31 December 2005 £bn	1 January 2005 £bn
Loans and advances to customers gross	7.8	7.1
Investment management assets excluding deposits	25.4	21.6
Customer deposits	25.5	22.3
Weighted risk assets	6.1	6.0

Total income rose by 5% to £814 million, reflecting good growth across all our businesses, and contribution was 14% higher at £408 million. Coutts UK and Adam & Co both gained good numbers of customers, with Coutts up 7% and Adam up 11%. 2005 also saw the continuation of rapid growth in Asia, where the number of private bankers increased by 20%, with particular emphasis placed on recruitment for the Chinese and Indian markets.

Net interest income increased by 10% to £442 million. Strong growth in average customer loans and deposits was partiallly offset by lower net interest margin due to a change in the mix of business.

Non-interest income was steady at £372 million. Average assets under management rose 9% to £23.1 billion as a result of good new business volumes in Coutts UK and the rise in equity markets. Assets under management at the year end were £25.4 billion, an increase of 18%.

Expenses decreased by 1% to £393 million, reflecting a continued focus on efficiency. Despite continued investment in growth markets in both the UK and overseas, staff costs were 2% lower than in 2004. Other costs reduced to £135 million.

Impairment losses amounted to £13 million, down £5 million.

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Ulster Bank

	2005 £m	2004 £m
Net interest income	655	550
Non-interest income	203	193
Total income	858	743
Expenses		
staff costs	191	172
other	79	79
	270	251
Contribution before impairment losses	588	492
Impairment losses	58	40
Contribution	530	452

	31 December 2005 £bn	1 January 2005 £bn
Total assets	35.9	28.7
Loans and advances to customers gross		
mortgages	13.2	10.1
other	15.0	12.9
Customer deposits	15.9	13.6
Weighted risk assets	22.4	18.6
Average exchange rate /£	1.463	1.474
Spot exchange rate /£	1.457	1.418

Total income increased by 15% to £858 million, with contribution up 17% to £530 million, as Ulster Bank achieved another year of strong growth, with excellent customer recruitment, robust lending volumes and very good growth in deposits. First Active continues to perform well and in line with our integration plan. It led the Republic of Ireland market with the introduction of new mortgage products, as well as launching new credit card and direct loan products.

The number of personal and business customers increased by 68,000 in the year. Ulster Bank personal customer numbers rose by 9% in the Republic of Ireland, where our switcher mortgage product has helped us to gain market share. In Northern Ireland, Ulster Bank significantly enhanced its personal current account offering in the fourth quarter to provide free banking to all customers.

Net interest income rose by 19% to £655 million. Average loans and advances and average customer deposits both grew strongly. However, the continuing strong growth in mortgages and business loans led to a decline in net interest margin.

Non-interest income increased by £10 million or 5% to £203 million. This reflected increased volumes of customer transactions and good growth in income from financial markets services.

Expenses increased by 8% to £270 million, as a result of investment to support the growth of the business. This investment will continue into 2006. We have continued with our branch improvement programme, upgrading 50 branches in the Republic of Ireland and 39 in Northern Ireland.

Impairment losses increased by £18 million to £58 million, reflecting the growth in lending.

Operating and financial review continued

Citizens

	2005 £m	2004 £m
Net interest income	2,122	1,609
Non-interest income	1,142	659
Total income	3,264	2,268
Expenses		
staff costs	819	580
other	739	500
	1,558	1,080
Contribution before impairment losses	1,706	1,188
Impairment losses	131	117
Contribution	1,575	1,071

	31 December 2005 US$bn	1 January 2005 US$bn
Total assets	158.8	141.7
Loans and advances to customers gross	104.6	91.7
Customer deposits	106.3	99.2
Weighted risk assets	106.4	93.5
Average exchange rate US$/£	1.820	1.832
Spot exchange rate US$/£	1.721	1.935

Citizens performed well in 2005, delivering a strong underlying performance in challenging market conditions both from the old Citizens franchise and from Charter One. Total income, in US dollars, rose by 43% to $5,940 million and contribution by 46% to $2,867 million, including a full years contribution from Charter One. Excluding Charter One and other acquisitions, income rose by 7% and contribution by 10%, despite the impact of the flattening of the yield curve, which reduced net interest margin and the rate of growth in net interest income.

We have grown our customer numbers in both personal and business segments, with Charter One increasing its small business and corporate customer base by 10%. Co-operation between Citizens and RBS Corporate Markets is yielding good results. Citizens new international cash management service has already won nearly 300 new accounts with existing RBS customers, bringing in more than $80 million of new core deposits.

Our cards businesses, which are only active in the prime and superprime segments, have made good progress. Credit card balances increased by 19% to $2.5 billion, as RBS National launched into a number of new channels such as Charter One branches. RBS Lynk, our merchant acquiring business, increased its customer base by 24%.

The integration of Charter One progressed well and all phases of the IT conversion were completed in July 2005, five months ahead of schedule. This involved the conversion to Citizens systems of over 750 branches and three million customer accounts spread over a wide geography. Despite the focus on the integration process, Charter One achieved good growth in business volumes, with loans and advances up 18% over the course of the year and customers deposits up 10%.

Net interest income increased by 31% to $3,861 million. This reflected strong growth in both lending and deposits. Excluding acquisitions, average lending increased by 13% or $6.7 billion, with robust growth in secured consumer lending, and average customer deposits by 9% or $5.7 billion. However, as a consequence of the flattening yield curve, net interest income excluding acquisitions was only 4% higher at $2,534 million.

Non-interest income was up 72% to $2,079 million. Excluding acquisitions, non-interest income grew by 15% to $1,004 million, benefiting from higher fee income, increased student loan and leasing activities, and investment gains.

Expenses were up 43% to $2,834 million. Expense growth, excluding acquisitions, was contained to 6%.

Impairment losses, including acquisitions, were up $25 million to $239 million. Credit quality overall remained stable. More than 90% of our personal sector lending is secured, and as a result there was minimal impact from the change in US bankruptcy laws in 2005.

RBS Insurance

	2005 £m	2004 £m
Earned premiums	5,641	5,507
Reinsurers share	(246)	(454)
Insurance premium income	5,395	5,053
Net fees and commissions	(449)	(481)
Other income	543	467
Total income	5,489	5,039
Expenses		
staff costs	323	304
other	413	314
	736	618
Gross claims	3,903	3,826
Reinsurers share	(76)	(268)
Net claims	3,827	3,558
Contribution	926	863

	31 December 2005	31 December 2004
In-force policies (000s)		
Motor: UK	8,687	8,338
Motor: Continental Europe	1,862	1,639
Non-motor (including home, rescue, pet, HR24): UK	10,898	10,464
General insurance reserves total (£m)	7,776	7,379

RBS Insurance produced a good performance in 2005, with total income increasing by 9% to £5,489 million and contribution by 7% to £926 million. The integration of Churchill was completed in September 2005, ahead of plan, and Churchill delivered greater transaction benefits than anticipated at the time of the acquisition. Following the integration of Churchill, all our direct general insurance businesses in the UK now operate on a common platform.

RBS Insurance achieved 4% growth in UK motor policies in force. In achieving this against a background of very strong competition in UK motor insurance, we benefited from the strength of our brands and the diversity of our distribution channels. Growth came through our direct brands, through our partnership business, where we operate insurance schemes on behalf of third parties who in turn sell insurance products to their customers, and through NIG, our intermediary business acquired as part of Churchill. Our businesses in Spain, Germany and Italy together delivered 14% growth in motor policies in force. Linea Directa, our joint venture with Bankinter, increased its customer base by 17% and, with more than 1 million policies, is the largest direct motor insurer and sixth largest

motor insurer in Spain.

Total home insurance policies declined by 1%. Within this total, we continued to expand through our direct brands but there was attrition of some partner-branded books.

In addition to expanding its intermediary business in motor and home insurance, NIG achieved 10% growth in commercial policies sold to SMEs.

Expenses rose by 19%. Excluding the impact of a change in reinsurance arrangements, total income rose by 6% and expenses by 9%. Net insurance claims on the same basis were up by 5%, reflecting increased volumes, claims inflation in motor and an increase in home claims following severe storms in the UK in January 2005.

The UK combined operating ratio for 2005 was 93.6%.

Operating and financial review continued

Manufacturing

	2005 £m	2004 £m
Staff costs	740	753
Other costs	2,003	1,799
Total manufacturing costs	2,743	2,552
Analysis:		
Group Technology	945	852
Group Purchasing and Property Operations	1,013	927
Customer Support and other operations	785	773
Total manufacturing costs	2,743	2,552

Manufacturing's costs increased by 7% to £2,743 million. Excluding software amortisation, costs rose by 4%. Costs relating to internal software development, which under UK GAAP were written off as incurred, are now under IFRS capitalised and amortised.

Group Technology costs increased by 11% to £945 million. Excluding software amortisation, costs were up 2%, with support for increased business volumes offset by efficiency improvements. The Group Efficiency Programme was substantially completed during the year, with major implementations such as a new system for handling customer queries and a new customer account-opening platform. The Churchill systems integration was completed in September 2005.

Group Purchasing and Property Operations costs increased by 9% to £1,013 million. We improved the efficiency of our property utilisation in 2005 while continuing our programme of investment both in the branch networks and in our major operational centres, including Birmingham, Manchester and our new headquarters in Edinburgh.

Customer Support and other operations costs rose by just 2%, despite a much greater increase in the business volumes supported. Cash withdrawals from ATMs, for example, rose by 13%, while we handled 10% more mortgage applications and 7% more personal loan volumes. These increases were absorbed by improved efficiency through the delivery of new systems and ways of working.

Central items

	2005 £m	2004 £m
Funding costs	810	274
Departmental and corporate costs	658	391
Total Central items	1,468	665

Total central items increased by £803 million to £1,468 million.

Funding costs at £810 million, were up £536 million largely because of the full year funding cost of the acquisition of Charter One in August 2004 and the effect of implementing IAS 32 (reclassification of funding costs on preference shares and trust preferred securities from dividends payable and minority interests respectively to interest payable). The Groups primary objective is to hedge its economic risks. So as not to distort divisional results, volatility attributable to derivatives in economic hedges that do not meet the criteria in IFRS for hedge accounting is transferred to the Groups central treasury function. This resulted in a charge of £45 million, in addition to a charge for £14 million for hedge ineffectiveness under IFRS.

Central departmental costs and other corporate items at £658 million were £267 million higher than 2004. This was principally due to higher pension costs and the centralisation of certain functions, and includes ongoing expenditure on regulatory projects such as Basel II and Sarbanes-Oxley Section 404.

Employee numbers at 31 December

	2005	2004
Corporate Markets	15,700	16,800
Retail Banking	33,100	32,200
Retail Direct	6,800	7,000
Wealth Management	4,200	4,100
Ulster Bank	4,400	4,100
Citizens	24,400	24,000
RBS Insurance	19,400	19,500
Manufacturing	26,800	26,900
Centre	2,200	2,000
Group total	137,000	136,600

2005 compared with 2004

The number of employees increased by 400 to 137,000, with increases in Retail Banking, Citizens and Ulster Bank partly offset by a reduction in Corporate Markets.

Operating and financial review continued

Consolidated balance sheet at 31 December 2005

	31 December 2005 £m	1 January 2005 £m	31 December 2004 £m
Assets			
Cash and balances at central banks	4,759	4,293	4,293
Treasury bills and other eligible bills	5,538	6,109	6,110
Loans and advances to banks	70,587	65,691	61,073
Loans and advances to customers	417,226	381,162	347,251
Debt securities	120,965	93,915	93,908
Equity shares	9,301	5,231	4,723
Intangible assets	19,932	19,242	19,242
Property, plant and equipment	18,053	16,425	16,428
Settlement balances	6,005	5,682	5,682
Derivatives at fair value	95,663	89,905	17,800
Prepayments, accrued income and other assets	8,798	8,855	11,612
Total assets	776,827	696,510	588,122
Liabilities			
Deposits by banks	110,407	106,026	99,883
Customer accounts	342,867	315,046	283,315
Debt securities in issue	90,420	66,245	63,999
Settlement balances and short positions	43,988	33,339	32,990
Derivatives at fair value	96,438	91,277	18,876
Accruals, deferred income and other liabilities	14,247	14,720	17,648
Retirement benefit liabilities	3,735	2,940	2,940
Deferred taxation liabilities	1,695	1,826	2,061
Insurance liabilities	7,212	6,592	8,647
Subordinated liabilities	28,274	27,526	20,366
Total liabilities	739,283	665,537	550,725
Equity			
Minority interests	2,109	951	3,492
Shareholders equity			
Called up share capital	826	822	822
Reserves	34,609	29,200	33,083
Total equity	37,544	30,973	37,397
Total liabilities and equity	776,827	696,510	588,122

Analysis of repurchase agreements included above

Reverse repurchase agreements and stock borrowing			
Loans and advances to banks	41,804	34,475	29,975
Loans and advances to customers	48,887	64,599	52,184
	90,691	99,074	82,159
Repurchase agreements and stock lending			
Deposits by banks	47,905	47,841	43,342
Customer accounts	48,754	54,485	42,134
	96,659	102,326	85,476

Overview of consolidated balance sheet

31 December 2005 compared with 31 December 2004

Total assets of £776.8 billion at 31 December 2005 were up £188.7 billion, 32%, compared with 31 December 2004, with £108.4 billion of this increase arising from the implementation of IAS 32, IAS 39 and IFRS 4 on 1 January 2005, and the balance reflecting business growth.

Treasury bills and other eligible bills decreased by £0.6 billion, 9%, to £5.5 billion, reflecting trading activity.

Loans and advances to banks rose £9.5 billion, 16%, to £70.6 billion. Of the increase, £4.6 billion was due to the implementation of IAS 32 and IAS 39, and the balance reflected growth in reverse repurchase agreements and stock borrowing (reverse repos), which increased by £7.3 billion, 21%, to £41.8 billion. This was partially offset by a decrease in bank placings, down £2.4 billion, 8% to £28.8 billion.

Loans and advances to customers were up £70.0 billion, 20%, at £417.2 billion of which £33.9 billion resulted from the implementation of IAS 32 and IAS 39, mainly due to the grossing up of previously netted customer balances. Customer lending was up £51.8 billion, 16%, reflecting organic growth across all divisions while reverse repos were down 24%, £15.7 billion to £48.9 billion.

Debt securities increased by £27.1 billion, 29%, to £121.0 billion, principally due to increased holdings in Corporate Markets.

Equity shares rose £4.6 billion, 97%, to £9.3 billion with most of the increase, £4.1 billion, 78%, mainly due to increased activity in Corporate Markets. Implementation of IAS 39 added £0.5 billion.

Intangible assets increased by £0.7 billion, 4% to £19.9 billion largely due to exchange rate movements.

Property, plant and equipment were up £1.6 billion, 10% to £18.1 billion, principally as a result of growth in operating lease assets.

Derivatives at fair value were higher by £77.9 billion at £95.7 billion, including £72.1 billion resulting from the implementation of IAS 32 and IAS 39, with £71.5 billion arising from the grossing up of previously netted balances. The remainder of the increase, £5.8 billion, 6%, primarily reflected higher trading volumes and movements in interest and exchange rates.

Prepayments, accrued income and other assets decreased by £2.8 billion, 24% to £8.8 billion, mainly due to the implementation of IAS 32 and IAS 39.

Deposits by banks increased by £10.5 billion, 11% to £110.4 billion, of which £6.1 billion arose from the implementation of IAS 32 and IAS 39. The remaining £4.4 billion was raised to fund business growth mainly higher inter-bank deposits, up £4.3 billion, 7% to £62.5 billion. Repurchase agreements and stock lending (repos) were largely flat at £47.9 billion.

Customer accounts were up £59.6 billion, 21% at £342.9 billion with £31.7 billion arising from the implementation of IAS 32 and IAS 39, largely reflecting the grossing up of previously netted deposits. Deposits rose by £33.5 billion, 13%, to £294.1 billion with good growth in all divisions. Repos decreased by £5.7 billion, 11% to £48.8 billion.

Debt securities in issue increased by £26.4 billion, 41%, to £90.4 billion, with £2.2 billion resulting from the implementation of IAS 39, and £24.2 billion raised primarily to meet the Group's funding requirements.

The increase in settlement balances and short positions, up £11.0 billion, 33%, largely reflected growth in customer activity.

Derivatives at fair value were up £77.6 billion to £96.4 billion, including £72.4 billion resulting from the implementation of IAS 32 and IAS 39, with £71.5 billion arising from the grossing up of previously netted balances. The remainder of the increase, £5.2 billion, 6% primarily reflected higher trading volumes and movements in interest and exchange rates.

Accruals, deferred income and other liabilities decreased by £3.4 billion, 19% to £14.2 billion, largely due to the implementation of IAS 32 and IAS 39.

Subordinated liabilities were up £7.9 billion, 39% to £28.3 billion, including £7.2 billion due to the reclassification as debt of the majority of the Group's existing preference share capital and non-equity minority interests following the implementation of IAS 32 and IAS 39. The balance, £0.7 billion, reflected the issue of £1.2 billion dated loan capital and exchange rate movements of £1.3 billion which were partially offset by the redemption of £1.6 billion non-cumulative preference shares and dated loan capital.

Minority interests decreased £1.4 billion, 40% to £2.1 billion, due to the reclassification of £2.6 billion as debt following the implementation of IAS 32 and IAS 39. This more than offset the increase in minority interests of £1.2 billion to £2.1 billion principally due to the co-investors interest in the Group's subsidiary that invested in Bank of China and the issuance of preferred securities.

Shareholders' equity increased by £1.5 billion, 5%, to £35.4 billion. The implementation of IAS 32 and IAS 39 reduced shareholders' equity by £3.9 billion, largely as a result of the reclassification as debt of the majority of the Group's preference share capital, £3.3 billion. The profit for the period of £5.5 billion, issue of £1.6 billion non-cumulative equity preference shares and £0.3 billion of ordinary shares in respect of scrip dividends and the exercise of share options, were partly offset by the payment of the 2004 final ordinary dividend, £1.3 billion, and the 2005 interim ordinary dividend, £0.6 billion, preference dividends of £0.1 billion and £0.6 billion actuarial losses, net of tax, recognised in post-retirement benefit schemes.

The fair value of the assets of the Group's post-retirement benefit schemes was £17.4 billion (2004 - £14.8 billion) and the present value of defined benefit obligations was £21.1 billion (2004 - £17.7 billion). The increase in net pension liability (after tax) to £2.7 billion from £2.1 billion is principally due to movements in interest rates. The mortality assumptions used in the valuation of liabilities were updated at the end of 2004 and have not been changed.

Operating and financial review continued

Cash flow

	2005 £m	2004 £m
Net cash flows from operating activities	8,950	2,493
Net cash flows from investing activities	(2,612)	(9,398)
Net cash flows from financing activities	(703)	7,119
Effects of exchange rate changes on cash and cash equivalents	(3,107)	1,686
Net increase in cash and cash equivalents	2,528	1,900

2005

The major factors contributing to the net cash inflow of £8,950 million from operating activities in 2005 were the profit before tax of £7,936 million, increases in deposits and debt securities in issue of £56,571 million, and increases in short positions and settlement balances of £10,326 million, partially offset by increases in securities of £28,842 million and in loans and advances of £36,778 million.

Net purchases of fixed assets, including operating lease assets and computer and other equipment, of £2,592 million were the main contributor to the net cash outflow from investing activities of £2,612 million.

The issue of £1,649 million preference shares and £1,234 million subordinated debt were more than offset by dividend payments of £2,007 million and the repayment of £1,553 million of subordinated liabilities, resulting in a net cash outflow from financing activities of £703 million.

2004

The major factors contributing to the net cash inflow of £2,493 million from operating activities in 2004 were the profit before tax of £7,284 million, increases in deposits and debt securities in issue of £72,146 million, and in short positions and settlement balances of £8,796 million, partially offset by increases in securities of £11,883 million and in loans and advances of £72,955 million.

Net purchases of fixed assets, including operating lease assets and computer and other equipment, of £2,662 million and net investment in business interests and intangible assets of £7,968 million led to the net cash outflow from investing activities of £9,398 million.

The issue of £1,358 million preference shares and £2,845 million ordinary shares, and £4,624 million subordinated liabilities, partly offset by the payment of £1,635 million of dividends, were the main contributors to the net cash inflow from financing activities of £7,119 million.

IFRS compared with US GAAP

The Groups financial statements are prepared in accordance with IFRS, which differ in certain material respects from US GAAP as described on pages 173 to 178.

The net income available for ordinary shareholders under US GAAP was £4,475 million, £917 million lower than profit attributable to ordinary shareholders under IFRS of £5,392 million. The principal reasons for the decrease are:

- a reduction of £556 million relating to financial instruments principally foreign exchange gains on available-for-sale securities recognised in net income under IFRS but included directly in equity under US GAAP together with the adjustment for financial assets and liabilities designated as at fair value through profit or loss; US GAAP does not permit such designation.

- higher pension costs under US GAAP compared with IFRS reflecting the deferral of actuarial gains and losses over the remaining service lives of current employees under US GAAP; such gains and losses are recognised in full in equity under IFRS.

US GAAP shareholders equity at £40,229 million is £4,794 million higher than IFRS equity of £35,435 million principally due to the inclusion of certain preference shares, classified as debt under IFRS, equity under US GAAP, the reinstatement of goodwill deducted from equity under previous GAAP, and the effect of deferring and amortising loan origination costs.

Capital resources

It is the Groups 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 FSA. The FSA uses Risk Asset Ratio (RAR) as a measure of capital adequacy in the UK banking sector, comparing a banks 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 2005, the Groups total RAR was 11.7% and the tier 1 RAR was 7.6%.

Upon the adoption of IFRS by listed banks in the UK on 1 January 2005, the Financial Services Authority ("FSA") changed its regulatory requirements such that the measurement of capital adequacy was based on IFRS subject to a number of prudential filters. The data as at 31 December 2005 set out below has been presented in compliance with these revised FSA requirements.

	2005 - IFRS £m
Capital base	
Tier 1 capital	28,218
Tier 2 capital	22,437
	50,655
Less: investments in insurance subsidiaries, associated undertakings and other supervisory deductions	(7,282)
Total capital	43,373

Weighted risk assets	
Banking book:	
On-balance sheet	303,300
Off-balance sheet	51,500
Trading book	16,200
	371,000
Risk asset ratios	%
Tier 1	7.6
Total	11.7

The data set forth below are in accordance with the FSA regulations in force at the time and are based on UK GAAP.

	2004 - UK GAAP £m	2003 - UK GAAP £m	2002 - UK GAAP £m	2001 - UK GAAP £m
Capital base				
Tier 1 capital	22,694	19,399	17,155	15,052
Tier 2 capital	20,229	16,439	13,271	11,734
Tier 3 capital	—	—	—	172
	42,923	35,838	30,426	26,958
Less: investments in insurance subsidiaries, associated undertakings and other supervisory deductions	(5,165)	(4,618)	(3,146)	(2,698)
Total capital	37,758	31,220	27,280	24,260
Weighted risk assets				
Banking book:				
On-balance sheet	261,800	214,400	193,800	176,000
Off-balance sheet	44,900	36,400	28,700	22,000
Trading book	17,100	12,900	11,500	12,500
	323,800	263,700	234,000	210,500
Risk asset ratios	%	%	%	%
Tier 1	7.0	7.4	7.3	7.1
Total	11.7	11.8	11.7	11.5

Operating and financial review continued

Risk management

Governance framework

The Board sets the overall risk appetite and philosophy for the Group. Various Board and executive sub-committees support these goals, as follows:

- **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 design, adequacy and effectiveness of the Group's internal controls.

- **Advances Committee** is a board committee that deals with all transactions that exceed the Group Credit Committee's delegated authority.

In addition to the responsibilities at Board level, 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 the following committees:

- **Group Risk Committee** ("GRC") is an executive risk governance committee which recommends and approves limits, processes and policies in respect of the effective management of all material non-balance sheet risks across the Group.

- **Group Credit Committee** ("GCC") is a credit approval committee which deals with all transactions that exceed the delegated authority of divisional credit committees.

- **Group Asset and Liability Management Committee** ("GALCO"), is an executive committee which is responsible for reviewing the balance sheet, funding, liquidity, structural foreign exchange, intra-group limits, capital adequacy and capital raising across the Group as well as interest rate risk in the banking book. In addition, GALCO monitors and reviews external, economic and environmental changes affecting such risks.

These Committees are supported by two dedicated group level functions, Group Risk Management (GRM), which has responsibility for credit, market, regulatory and enterprise risk and Group Treasury which is responsible for the management of the Groups balance sheet, capital raising, intra group credit exposure, liquidity and hedging policies. Both functions report to GEMC and the Group Board through the Group Finance Director and play an active role in assessing and monitoring the effectiveness of the divisional risk management functions. Heads of Group Risk Mangement and Internal Audit have direct access to the Group Chief Executive and the Chairman of the Group Audit Committee.

Risk management

The principal risks that the Group manages are as follows:

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

- **Liquidity risk:** is the risk that the Group is unable to meet its obligations as they fall due.

- **Market risk:** the Group is exposed to market risk because of positions held in its trading portfolios and its non-trading businesses.

- **Insurance risk:** the Group is exposed to insurance risk, either directly through its businesses or through using insurance as a tool to mitigate other risk exposures.

- **Enterprise risk:** the Group separately defines operational and external risk. Operational risk is defined as the risk arising from the Group's people, processes, systems and assets. External risk comprises business, political and environmental risk.

- **Regulatory risk:** is the risk arising from failing to meet the requirements and expectations of our many regulators, or from a failure to address or implement any change in these requirements or expectations.

Principal risk types

<table>
<tr><td colspan="4">Regulatory risk</td></tr>
<tr><td>Credit risk</td><td>Liquidity risk</td><td>Market risk</td><td>Insurance risk</td></tr>
<tr><td colspan="4">Enterprise risk</td></tr>
</table>

Risk appetite

Risk management across the Group is based on the risk appetite and philosophy set by the Board and the associated risk committees. The Board establishes the parameters for risk appetite for the Group through:

- Setting strategic direction.
- Contributing to, and ultimately approving annual plans for each division.
- Regularly reviewing and monitoring the Group's performance in relation to risk through monthly Board Reports.

The Board delegates the articulation of risk appetite to GEMC and ensures that this is in line with the strategy and the desired risk reward trade off for the Group. Risk appetite is an expression of the maximum level of residual risk that the Group is prepared to accept in order to deliver its business objectives and is assessed against regular (often daily) controls and stress testing to ensure that the limits are not compromised in abnormal circumstances.

Risk appetite is usually defined in both quantitative and qualitative terms. Whilst different techniques are used to ensure that the Group's risk appetite is achieved, generically they can be classified as follows:

- **Quantitative:** encompassing stress testing, risk concentration, value at risk and credit related metrics, including the probability, loss and exposure at default.

- **Qualitative:** focuses on ensuring that the Group applies the correct principles, policies and procedures.

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

Qualitative and quantitative elements of risk management

Operating and financial review continued

Risk organisation

Divisional CEOs are specifically responsible for the management of risk within their divisions. As such, they are responsible for ensuring that they have appropriate risk management frameworks that are adequate in design, effective in operation and meet minimum Group standards.

Divisional CEOs are supported by divisional Chief Risk Officers (CROs) and Chief Financial Officers (CFOs). An important element that underpins the Groups approach to the management of all risk is independence. In the case of CROs, it is enforced by joint reporting lines, both operationally to the divisional CEO and functionally to the Group Chief Risk Officer.

Credit risk

Key principles of credit risk management

The objective of credit risk management is to enable the Group to achieve sustainable and superior risk versus reward performance whilst maintaining credit risk exposure in line with approved risk appetite.

Group Risk Management is responsible for setting standards for maintaining and developing credit risk management throughout the Group. This is achieved via a combination of governance structures, credit risk policies, control processes and credit systems collectively known as the Groups Credit Risk Management Framework (CRMF). The framework is defined in detail in the Groups Principles for Managing Credit Risk.

The key principles for credit risk management as defined in the CRMF include:

- Approval of all credit exposure must be granted prior to any advance or extension of credit.
- An appropriate credit risk assessment of the customer and related credit facilities must be undertaken prior to approval of credit exposure. This must include a review of, amongst other things, the purpose of the credit and sources of repayment, compliance with affordability tests, repayment history, capacity to repay, sensitivity to economic and market developments and risk-adjusted return.
- The Board delegates authority to Executive Advances Committee, Group Credit Committee and divisional credit committees.
- Credit risk authority must be specifically granted in writing to all individuals involved in the granting of credit approval, whether this is exercised personally or collectively as part of a credit committee. In exercising credit authority, the individuals must act independently and with balanced commercial judgement.
- Where credit authority is exercised personally, the individual must not have any responsibility or accountability for business revenue generation.
- All credit exposures, once approved, must be effectively monitored and managed and reviewed periodically against approved limits. Lower quality exposures are subject to a greater frequency of analysis and assessment.
- Customers with emerging credit problems must be identified early and classified accordingly. Remedial actions must be implemented promptly to minimise the potential loss to the Group.
- Portfolio analysis and reporting must be used to identify and manage credit risk concentrations and credit risk quality migration.

Each Division must establish its own CRMF consistent with the Group CRMF. Divisional credit departments are responsible for maintaining the CRMF and ensuring that asset quality is within specified parameters. Divisional credit departments are independent of business management and have no direct responsibility or accountability for revenue generation. This independence is supported by the divisional head of credit having dual reporting lines to the both the divisional CEO (via the divisional Chief Risk Officer) and to the Head of Group Credit Risk.

GRM undertakes regular assessment of the effectiveness of each divisional CRMF to ensure it complies with Group standards and is appropriate for the business being undertaken. GRC and the GEMC review reports on the Group's portfolio of credit risks on a monthly basis.

Credit approval process

Different credit approval processes exist for each customer type in order to ensure appropriate skills and resources are employed in credit assessment and approval whilst following the key principles relating to credit approval.

Wholesale risk exposures are aggregated to determine the appropriate level of credit approval required and to facilitate consolidated credit risk management.

Credit authority is not extended to relationship managers:

- Assessments of corporate borrower and transaction risk are undertaken using a range of credit risk models supplemented, where appropriate, by management judgement. Specialist internal credit risk departments independently oversee the credit process and make credit decisions or recommendations to the appropriate credit committee.
- Financial Markets counterparties are subject to similar modelling techniques but are approved by a dedicated credit function which specialises in traded market product risk.

Consumer lending and personal businesses employ 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 are individually assessed.

Credit risk models

Credit risk models are used throughout the Group to support the analytical elements of the credit risk management framework, in particular the quantitative risk assessment part of the credit approval process, ongoing credit monitoring as well as portfolio level analysis and reporting.

Credit risk modelling governance

The Groups Principles for Managing Credit Risk outline the governance structure under which all credit risk models must be developed, reviewed and approved. GRM is responsible for:

- Establishing high level standards to which all credit risk models across the Group must adhere and thus ensuring a consistency of approach to credit risk modelling across the Group.
- Approving all credit risk models prior to implementation and reviewing existing models on at least an annual basis.

Divisional credit risk departments own the particular models and are responsible for:

- Developing credit risk models appropriate for the types of borrower and facilities in their credit portfolios and obtaining approval from GRM for their implementation.
- Validating the models on at least an annual basis (every two years for credit risk exposure measurements models) and submitting documentation of these validations to GRM with appropriate recommendations on recalibration, where applicable.
- Obtaining approval from GRM for any new methodology or parameter estimates used in existing credit risk models prior to implementation.

Credit risk models used by the Group can be broadly grouped into four categories.

- **Probability of default (PD)/customer credit grade** these models assess the probability that the customer will fail to make full and timely repayment of credit obligations over a one year time horizon. Each customer is assigned an internal credit grade which corresponds to probability of default. There are a number of different credit grading models in use across the Group, each of which considers particular customer characteristics in that portfolio. The credit grading models use a combination of quantitative inputs, such as recent financial performance and customer behaviour, and qualitative inputs, such as company management performance or sector outlook.

  Every customer credit grade across all grading scales in the Group can be mapped to a Group level credit grade (see page 42).

- **Exposure at default (EAD)** these models estimate the expected level of utilisation of a credit facility at the time of a borrowers default. The EAD will typically be higher than the current utilisation (e.g. in the case where further drawings are made on a revolving credit facility prior to default) but will not typically exceed the total facility limit. The methodologies used in EAD modelling recognise that customers may make more use of their existing credit facilities in the run up to a default.

- **Loss given default (LGD)** these models estimate the economic loss that may be suffered by the Group on a credit facility in the event of default. The LGD of a facility represents the amount of debt which cannot be recovered and is typically expressed as a percentage of the EAD. The Groups LGD models take into account the type of borrower, facility and any risk mitigation such as the presence of any security or collateral held. The LGD may also be affected by the industry sector of the borrower, the legal jurisdiction in which the borrower operates as well as general economic conditions which may impact the value of any assets held as security.

- **Credit risk exposure measurement** these models calculate the credit risk exposure for products where the exposure is not 100% of the gross nominal amount of the credit obligation. These models are most commonly used for derivative and other traded instruments where the amount of credit risk exposure may be dependent on external variables such as interest rates or foreign exchange rates.

Operating and financial review continued

Credit risk assets

Credit risk assets measure the exposure to all products in the Groups credit portfolios which consist of loans and advances (including overdraft facilities), instalment credit, finance lease receivables, debt securities and other traded instruments across all customer types.

Credit risk assets are typically analysed excluding reverse repurchase agreements due to the short-term nature and low credit risk associated with this product. A breakdown of credit risk assets by division is shown below.

Credit risk assets	2005 £bn	2004 £bn
Corporate Markets	273.0	235.2
Retail Banking	78.0	72.2
Retail Direct	26.6	21.7
Wealth Management	8.9	10.7
Citizens	74.5	59.4
RBS Insurance	6.7	6.1
Ulster Bank	30.5	22.3
	498.2	427.6

Excluding reverse repurchase agreements, credit risk assets at 31 December 2005 were £498.2 billion (2004 £427.6 billion), an increase of £70.6 billion (17%) during the year.

An analysis of reverse repurchase agreements is shown below.

Reverse repurchase agreements	31 December 2005 £bn	1 January 2005 £bn
Banks	41.8	34.5
Customers	48.9	64.6
	90.7	99.1

Reverse repurchase agreements as at 31 December 2005 were £90.7 billion (1 January 2005 £99.1 billion), a decrease of £8.4 billion (8%) during the year.

Credit 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 various credit grading models that reflect the probability of default. All credit ratings across the Group map to a Group level asset quality scale.

Expressed as an annual probability of default, the upper and lower boundaries and the midpoint for each of these Group level asset quality grades are as follows:

Asset quality grade	Annual probability of default Minimum %	Midpoint %	Maximum %	S&P equivalent
AQ1	0.02	0.10	0.20	AAA to BBB-
AQ2	0.21	0.40	0.60	BB+ to BB
AQ3	0.61	1.05	1.50	BB- to B+
AQ4	1.51	3.25	5.00	B+ to B
AQ5	5.01	15.00		B and below

Distribution of credit risk assets by asset quality

Overall credit asset quality remained stable during 2005. As at 31 December 2005, exposure to investment grade counterparties (AQ1) accounted for 47% (2004 49%) of credit risk assets and 98% (2004 97%) of exposures were to counterparties rated AQ4 or higher. The exposure to the lowest asset quality (AQ5) reduced from 2.6% at 31 December 2004 to 2.2% at 31 December 2005.

Note: Graph data are shown net of provisions and reverse repurchase agreements.

Distribution of credit risk assets by industry sector

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

The Group also uses scenario analysis and stress testing in order to monitor the risk to clusters of correlated industry sectors.

Note: Graph data are shown net of provisions and reverse repurchase agreements.

As at 31 December 2005, 30% of credit risk assets (2004 30%) relate to individuals (personal and retail customers) and include mortgage lending and other smaller loans that are intrinsically well-diversified. Corporate industry sectors, including public sector and quasi government, account for 48% (2004 46%) of credit risk assets, with banks and other financial institutions representing the remaining 22% (2004 24%) of credit risk assets.

Operating and financial review continued

Distribution of credit risk assets by geography

The Group is currently active in 27 countries, with its principal focus on the UK, North America and Europe.

During 2005 there was further geographic diversification of credit risk assets away from the UK and into the rest of Europe and North America. As at 31 December 2005, 49.3% of credit risk assets were within the UK. North America and Europe account for 45.5% of credit risk assets with the remaining 5.2% in the rest of the world.

Distribution of credit risk assets by product and customer type

The Group also monitors the breakdown of the credit portfolio by customer type and product type. The Groups largest exposure by credit risk assets is corporate customer lending products which represent 31% of credit risk assets as at 31 December 2005 (2004 30%). As illustrated in the industry analysis this exposure is well diversified across industry sectors.

Loan impairment

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

Both REIL and PPL are reported gross of the value of any security held, which could reduce the eventual loss should it occur, and gross of any provision marked. Therefore impaired assets which are highly collateralised, such as mortgages, will have a low coverage ratio of provisions held against reported impaired balance.

The adoption of IAS 39 under IFRS at the start of 2005 resulted in changes to the methodology used to identify impaired assets and therefore the way that REIL is calculated. Comparative financial information is given in the following tables for both 1 January 2005 and 31 December 2004. Commentary is based on comparison with information at 1 January 2005, which reflects the impact of IAS 32, IAS 39 and IFRS 4.

The table below sets out the Group's loans that are classified as REIL and PPL:

REIL and PPL	31 December 2005 £m	1 January 2005 £m	31 December 2004 £m
Non-accrual loans(1)	5,926	5,836	4,733
Accrual loans past due 90 days(2)	9	52	713
Troubled debt restructurings(3)	2	—	24
Total REIL	5,937	5,888	5,470
PPL(4)	19	11	280
Total REIL and PPL	5,956	5,899	5,750
REIL and PPL as % of lending to customers loans and advances — gross(5)	1.60%	1.84%	1.92%

* following the implementation of IAS 39, the sub-categories of REIL and PPL are calculated as per notes 1 to 4 below.

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

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

(3) Troubled debt restructurings represent loans that have been restructured following the granting of a concession by the Group to the borrower.

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

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

REIL as at 31 December 2005 was £5,937 million (1 January 2005 — £5,888 million), an increase of £49 million (1%) during the year. As a % of customer lending, REIL and PPL in aggregate show an improving trend, amounting to 1.60% of customer loans and advances at 31 December 2005 (1 January 2005 — 1.84%).

REIL by division

The table below shows REIL by division.

REIL	31 December 2005 £m	1 January 2005 £m	31 December 2004 £m
Corporate Markets	1,465	2,098	1,892
Retail Banking	2,988	2,526	2,399
Retail Direct	889	671	601
Wealth Management	58	65	99
Ulster Bank	342	389	341
Citizens	195	136	135
RBS Insurance	—	3	3
Total REIL	5,937	5,888	5,470

During 2005 REIL in Corporate Markets reduced by £633 million reflecting continued favourable conditions in the corporate environment in UK, Europe and the US. This was offset by a combined increase in REIL in Retail Banking and Retail Direct of £680 million (21%) due to the weakening of the consumer environment in the UK.

Operating and financial review continued

Impairment loss provision methodology

Provisions for impairment losses are assessed under three categories as described below:

Individually assessed provisions are the provisions required for individually significant impaired assets which are assessed on a case by case basis, taking into account the financial condition of the counterparty and any guarantor. This incorporates an estimate of the discounted value of any recoveries and realisation of security or collateral. The asset continues to be assessed on an individual basis until it is repaid in full, transferred to the performing portfolio or written-off.

Collectively assessed provisions are provisions on impaired credits below an agreed threshold which are assessed on a portfolio basis, to reflect the homogeneous nature of the assets, such as credit cards or personal loans. The provision is determined from a quantitative review of the relevant portfolio, taking account of the level of arrears, security and average loss experience over the recovery period.

Latent loss provisions are provisions held against the estimated impairment in the performing portfolio which have yet to be identified as at the balance sheet date. To assess the latent loss within the portfolios, the Group has developed methodologies to estimate the time that an asset can remain impaired within a performing portfolio before it is identified and reported as such.

Provision analysis

The Groups consumer 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 methods.

Corporate portfolios consist of higher value, lower volume credits, which tend to be structured to meet individual customer requirements. Provisions are assessed on a case by case basis by experienced specialists, as well as professional valuations of collateral and the expert judgement of accountants. The Group operates a clear provisions governance framework which sets thresholds whereby suitable oversight and challenge is undertaken. These opinions and levels of provision are overseen by the divisions Provision Committee chaired by its Chief Executive, with representation from Group Risk Management. In addition, significant cases are presented to, and challenged by, the Group Problem Exposure Review Forum chaired by the Group Chief Executive or the Group Finance Director.

Early and active 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.

Portfolio provisions are reassessed regularly as part of the Groups ongoing monitoring process.

The adoption of IAS 39 under IFRS at the start of 2005 resulted in changes to the methodology used to identify impaired assets and to calculate required provisions.

Loan impairment charge	2005 £m	2004 £m
Latent loss provisions charge	14	
Collectively assessed provisions charge	1,399	
Individually assessed provisions charge	290	
Specific provision charge		1,386
General provision charge		16

Total charge to income statement	1,703	1,402
Charge as a % of customer loans and advances gross[1]	0.46%	0.47%

Notes:

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

Provisions for loan impairment charged to the income statement in 2005 were £1,703 million, up £301 million (21%) from 2004. As a percentage of customer lending, the impairment charge improved slightly from 0.47% to 0.46%.

Summary of loan impairment provisions

A summary of the total customer provisions balance is shown in the table below.

Loan impairment provisions[1]	31 December 2005 £m	1 January 2005 £m	31 December 2004 £m
Latent loss provisions	543	570	
Collectively assessed provisions	2,587	2,484	
Individually assessed provisions	754	1,086	
Specific provisions			3,607
General provision			561
Total provisions	3,884	4,140	4,168
Total provision as a % of customer loans and advances gross[2]	1.0%	1.3%	1.4%

Notes:

(1) Excludes provisions against loans and advances to banks of £3 million (1 January 2005 £5 million; 31 December 2004 £6 million).

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

As at 31 December 2005 total customer provisions were £3,884 million, down £256 million (6%) from 1 January 2005. The movement in provisions balance is shown at the bottom of the page.

Provisions coverage

The Groups provision coverage ratios are shown in the table below.

	31 December 2005	1 January 2005	31 December 2004
Total provision expressed as a:			
% of REIL	65%	70%	76%
% of REIL and PPL	65%	70%	72%

The coverage ratio of closing provisions to REIL and PPL decreased from 70% to 65% during 2005. The lower coverage ratio reflects a change of mix in the portfolios to more secured assets (e.g. residential mortgages) which, due to the level of collateral held, require a much lower level of provision.

Movement in loan impairment provisions balance

The movement in provisions balance during 2005 is shown in the table below.

	£m
Balance as at 1 January 2005	4,145
Currency and other adjustments	51

Amounts written-off	(2,040)
Recoveries of amounts previously written-off	172
Charge to income statement	1,703
Discount unwind(1)	(144)
Balance as at 31 December 2005[(2)]	3,887

Notes:

(1) The impact of discounting inherent within the provisions balance is unwound as the time to receiving the expected recovery cash flows draws nearer.

(2) Includes provisions against loans and advances to banks of £3 million (1 January 2005 £5 million).

An impairment provision calculated using the effective interest rate method leaves a discounted asset; the discount unwinds at a constant effective rate until the outstanding asset is completely realised.

Operating and financial review continued

Liquidity risk

Liquidity risk management within the Group focuses on both overall balance sheet structure and the day-to-day 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, which reviews monthly, and receives on an exception basis, reports detailing compliance with those policy parameters. A weekly report is also provided to the Groups executive management. Compliance is monitored and coordinated daily under the stewardship of the Group Treasury function, both in respect of internal policy and the regulatory requirements of the Financial Services Authority.

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 Groups 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, subject to Group Treasury oversight.

Diversification of funding sources

The structure of the Groups 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. As part of the Groups planning process, the forecast structure of the balance sheet is regularly reviewed over the plan horizon and funding strategies and options are developed by Group Treasury and implemented after review and approval by GALCO.

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 regularly to monitor concentration and identify any adverse trends. During 2005 the composition of the Groups funding sources remained well diversified by counterparty, instrument, market and maturity.

Sources of funding	2005 £m	%	2004 £m	%
Customer accounts (excluding repos)				
Repayable on demand	172,853	27	169,016	32
Time deposits	121,260	19	72,165	14
Total customer accounts (excluding repos)	294,113	46	241,181	46
Debt securities over 1 year remaining maturity	22,293	3	9,931	2
Subordinated liabilities	28,274	4	20,366	4
Shareholders equity	35,435	6	33,905	6
	380,115	59	305,383	58
Debt securities up to 1 year remaining maturity	68,127	11	54,068	10
Repo agreements with customers	48,754	7	42,134	8
Deposits by banks (excluding repos)	62,502	10	56,541	11
Repo agreements with banks	47,905	7	43,342	8
Short positions	37,427	6	28,923	5

Total	644,830	100	530,391	100

Customer accounts (excluding repos), term debt securities of over 1 year remaining maturity, subordinated liabilities and capital continue to represent the core of the Group's funding. These core funds in total increased by £74,732 million (24%) over the course of 2005 to represent 59% of total funding excluding other liabilities at 31 December 2005.

Customer accounts continue to provide a substantial proportion of the Group's funding and comprise a well diversified and stable source of funds from a wide range of retail, corporate and non-bank institutional customers. Excluding repo agreements, customer accounts grew by £52,932 million (22%), to maintain 46% of total funding excluding other liabilities at 31 December 2005.

Term debt securities with an outstanding term of over 1 year increased £12,362 million (124%) to represent 3% of the Group's funding at 31 December 2005, reflecting the activity of the Group in raising term funds through its Euro and US Medium Term Note and securitisation programmes.

Capital (shareholders' equity and subordinated debt) increased by £9,438 million (17%) and provides around 10% of total funding excluding other liabilities.

Short term wholesale deposits are taken from a wide range of counterparties, with the largest single depositor continuing to represent less than 1% of the Groups total funding. The level of funding from short term unsecured debt issuance and bank deposits, excluding repos and short positions, has increased by £20,020 million (18%) to represent 20% of total funding excluding other liabilities at 31 December 2005, reflecting the higher rate of growth in customer loans and advances (see net customer activity below).

Short positions and repos with corporate, institutional customers and banks are undertaken primarily by RBS Greenwich Capital in the US and by Financial Markets. Repo and short positions increased by £19,687 million (17%) to represent 21% of total funding excluding other liabilities at 31 December 2005.

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

Net customer activity

Net customer lending, excluding repos, rose by £20,056 million as the growth in loans and advances to customers continued to exceed the growth in customer accounts, thus increasing the degree of reliance on wholesale market funding to support loan growth.

Net customer activity	2005 £m	2004 £m
Loans and advances to customers (gross, excluding reverse repos)	372,223	299,235
Customer accounts (excluding repos)	294,113	241,181
Customer lending less customer accounts	78,110	58,054
Loans and advances to customers as a % of customer accounts (excluding repos)	126.6%	124.1%

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 is likely, in the medium term, to continue to exceed that for customer deposits received, thus increasing net customer lending further and increasing gradually over time the Groups dependence on the wholesale market for funding.

The Group evaluates on a regular basis a range of balance sheet management and term funding strategies to address the consequent potential impact on its structural liquidity risk position and maintain that within its normal policy parameters.

Management of term structure

The degree of maturity mismatch within the overall long-term structure of the Groups 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.

Stress testing

The maintenance of high quality credit ratings is recognised as an important component in the management of the Groups liquidity risk. Credit ratings affect the Groups ability to raise, and the cost of raising, funds from the wholesale market and the need to provide collateral in respect of, for example, changes in the mark-to-market

value of derivative transactions.

Given its strong credit ratings, the impact of a single notch downgrade would, if it occurred, be expected to have a relatively small impact on the Group's economic access to liquidity. More severe downgrades would have a progressively greater impact but have an increasingly lower probability of occurrence.

As part of its stress testing of its access to sufficient liquidity, the Group regularly evaluates the potential impact of a range of levels of downgrade in its credit ratings and carries out stress tests of other relevant scenarios and sensitivity analyses.

Contingency funding plans are maintained to anticipate and respond to any approaching or actual material deterioration in market conditions or in the Group's credit ratings, and the Group remains confident of its ability to manage its liquidity requirements effectively in all such circumstances.

Daily risk management

The primary focus of the Group's day to day risk management activity is to ensure access to sufficient liquidity to meet its cashflow obligations within key time horizons out to one month ahead. The short-term maturity structure of the Group's liabilities and assets is managed on a daily basis to ensure that all material cashflow obligations, and potential cashflows 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 various debt securities held (after allowing for appropriate haircuts).

Operating and financial review continued

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 local 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.

Net short-term wholesale market activity	2005 £m	2004 £m
Debt securities, treasury bills and other eligible bills	126,503	100,018
Reverse repo agreements with banks and customers	90,691	82,159
Less: repos with banks and customers	(96,659)	(85,476)
Short positions	(37,427)	(28,923)
Insurance Companies' debt securities held	(5,724)	(5,029)
Debt securities charged as security for liabilities	(9,578)	(4,852)
Net marketable assets	67,806	57,897
By remaining maturity up to 1 month:		
Deposits by banks (excluding repos)	35,153	34,041
Less: loans and advances to banks (gross, excluding reverse repos)	(16,381)	(17,067)
Debt securities in issue	20,577	15,505
Net wholesale liabilities due within 1 month	39,349	32,479
Net surplus of marketable assets over wholesale liabilities due within 1 month	28,457	25,418

The Group's net surplus of marketable assets over net short-term wholesale liabilities due within one month increased by £3,039 million to £28,457 million at 31 December 2005. Overall access to liquidity to meet all foreseen needs remains comfortably within the Group's policy parameters.

Sterling liquidity

Over 42% of the Group's total assets are denominated in sterling. For its sterling activity 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 five 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 exceeded the minimum ratio requirement throughout 2005.

The FSA also set 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 2005.

The Groups 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 currently 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 Groups total deposit and debt 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 Groups 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 Groups non-sterling liquidity risk. Particular attention is given to the US$ commercial paper market and the propensity of the Groups 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 £11 billion at 31 December 2005. 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 2005 and operational processes are actively managed to ensure that is the case going forward.

Developments in liquidity risk management regulation

Following the Basel Committee's publication of Sound Practices for Managing Liquidity in Banking Organisations in February 2000, a number of regulatory bodies internationally began reviewing their regulatory liquidity frameworks.

In the UK, the FSA published a discussion document – DP24 – in October 2003 setting out draft proposals for a new quantitative framework to operate in the UK. Comments made to the FSA, by the Group and other banks collectively, in response to these proposals, made clear the desirability of an internationally coordinated approach to the regulation of liquidity. An international forum of regulators, chaired jointly by the FSA and the US Federal Reserve Bank, was also established in 2004 to review regulation across the OECD. Their report is awaited. In 2005, the European Commission has also begun to consider the subject.

Following earlier consultation, the FSA also introduced in January 2005, new requirements for liquidity management systems and controls, particularly in respect of stress testing, contingency funding plans and related documentation. The Group has complied with these requirements and will continue to do so going forward.

The Group has been, and continues to be, actively involved in working with the various regulatory bodies to assist the development of an appropriate future regulatory liquidity regime which takes into account local national considerations but also gives due recognition to the integrated cross-border approach to the management of liquidity risk within most international banking groups.

Taking account of the indicative future regulatory requirements published to date, the Group continues to develop its liquidity risk reporting, management and stress testing capabilities.

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 19 on the accounts.

Operating and financial review continued

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

	2005				2004			
Trading	Average £m	Period end £m	Maximum £m	Minimum £m	Average £m	Period end £m	Maximum £m	Minimum £m
Interest rate	7.3	7.4	10.9	5.1	6.0	5.4	8.5	4.1
Credit spread	11.4	11.8	14.4	8.8	8.6	10.4	12.0	5.1
Currency	1.8	1.4	10.7	0.5	1.1	1.2	2.7	0.5
Equity and commodity	0.5	0.7	1.1	0.2	0.8	0.4	2.1	0.3
Diversification		(8.5)				(6.5)		
Total trading VaR	13.0	12.8	16.5	9.9	10.6	10.9	16.0	6.3

The Group□s trading activities are carried out principally by Global Banking & Markets. The charts below depict the number of days on which Global Banking & Markets□ trading income fell within the stated ranges.

2005

2004

Non-trading

The principal market risks arising from the Groups 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 Groups investments in overseas subsidiaries, associates and branches. The Groups venture capital portfolio and investments held by its general insurance business are the principal sources of non-trading equity price risk. The Groups 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 Groups 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 Groups treasury activities and retail and corporate banking businesses.

Treasury

The Groups treasury activities include its money market business and the management of internal funds flow within the Groups businesses. Money market portfolios include cash instruments (principally debt securities, loans and deposits) and related hedging derivatives. VaR for the Groups treasury portfolios, which relates mainly to interest rate risk including credit spreads, was £3.5 million at 31 December 2005 (2004 £5.7 million). During the year the maximum VaR was £5.8 million (2004 £9.3 million), the minimum £2.8 million (2004 £5.7 million) and the average £4.0 million (2004 £7.3 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 property, plant and equipment 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 accrual income exposures are measured and controlled in terms of sensitivity over time to movements in interest rates.

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

Non-trading interest rate VaR

Non-trading interest rate VaR for the Group’s treasury and retail and corporate banking activities was £81.5 million at 31 December 2005 (2004 – £72.4 million) with the major exposure being to changes in longer term US dollar interest rates. During the year, the maximum VaR was £104.2 million (2004 –£89.7 million), the minimum £10.8 million (2004 – £51.5 million) and the average £65.5 million (2004 – £71.2 million).

Citizens was the main contributor to the Group’s non-trading interest rate VaR. It invests 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. 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 the Board are:

- the sensitivity of net accrual earnings to a series of parallel movements in interest rates; and
- economic value of equity (“EVE”) sensitivity to a series of parallel movements in interest rates.

Operating and financial review continued

The limits applied to these measures are set to parallel movements of +/-1% and +/-2%. The EVE methodology captures deposit repricing strategies and the embedded option risks that exist 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	
2005	2% parallel upward movement in US interest rates %	2% parallel downward movement in US interest rates (no negative rates allowed) %
Period end	(9.1)	(8.2)
Maximum	(10.1)	(9.8)
Minimum	(7.1)	(4.4)
Average	(9.2)	(7.9)
2004		
Period end	(9.2)	(4.4)
Maximum	(12.6)	(18.5)
Minimum	(5.2)	(4.4)
Average	(9.3)	(9.2)

For the Group, 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 practical 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 stress scenarios including the impact of substantial declines in rates to ensure that appropriate risk management strategies are employed. Resulting action may involve execution of derivatives, product development and tactical pricing changes.

Note 34 on the accounts includes, on pages 147 and 148, tables that summarise the Groups interest rate sensitivity gap for its non-trading book at 31 December 2005 and 31 December 2004. 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 Groups 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 foreign subsidiaries and associated undertakings and their related currency funding. The Groups policy in relation to structural positions is to match fund the structural foreign currency exposure arising from net asset value, including goodwill, in foreign subsidiaries, equity accounted investments and branches, except where doing so would materially increase the sensitivity of either the Groups or the subsidiarys regulatory capital ratios to currency movements. The policy requires structural foreign exchange positions to be reviewed regularly by GALCO. Foreign exchange differences arising on the translation of foreign operations are recognised directly in equity together with the effective portion of foreign exchange

differences arising on hedging liabilities.

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

2005	Net investments in foreign operations £m	Foreign currency borrowings hedging net investments £m	Structural foreign currency exposures £m
US dollar	15,452	6,637	8,815
Euro	2,285	139	2,146
Swiss franc	431	430	1
Chinese RMB	914	–	914
Other non-sterling	76	72	4
	19,158	7,278	11,880
2004			
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

The US dollar open structural foreign currency exposure reflects the action taken to mitigate the effect of the acquisition in 2004 of Charter One on the Group's capital ratios. However, the increase in this position and the Euro structural exposure over 2004 is largely a result of the exclusion from the table of preference shares classified as equity under IFRS. These instruments continue to be considered part of the currency funding of foreign operations for asset and liability management purposes. The exposure in Chinese RMB arises from the Group's strategic investment in Bank of China.

– Equity risk

Non-trading equity risk arises principally from the Group's strategic investments, its venture capital activities and its general insurance business. General insurance investment strategy is discussed below under insurance risk.

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. These investments are carried at fair value with changes in fair value recorded in profit or loss, or in equity.

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.

An insurance contract transfers risk from the policyholder to the insurer, whereby, in return for a premium paid, the insurer indemnifies the policyholder on the occurrence of specified events.

Insurance risk is the risk of fluctuations in the timing, frequency and severity of insured events, relative to the expectations of the Group at the time of underwriting. This risk is managed according to the following separate components:

- Underwriting and pricing risk
- Claims management risk
- Reinsurance risk
- Reserving risk

Insurance risk is predictable, especially with the analysis of large volumes of data over time. There is, however, uncertainty around the predictions from various sources, for example, volatility of the weather. However, the Group has documented risk policies, coupled with governance frameworks to oversee and control and hence minimise the risks.

Underwriting and pricing risk

The Group manages underwriting and pricing risk through a wide range of processes and forums, which include:

- Underwriting guidelines which exist for all business transacted restricting the types and classes of business that may be accepted;

- Pricing policies which are set by pricing committees, by product line and by brand;

- Centralised control of policy wordings and any subsequent changes

Reinsurance and insurance of Group assets are centrally controlled in the same department as insurance risk and both have a similar framework of robust controls and processes.

Operating and financial review continued

Claims management risk

Claims management risk is the risk that claims are paid inappropriately. Claims are managed using a range of IT system controls and manual processes conducted by experienced staff, to ensure that claims are handled in a timely and accurate manner. Detailed policies and procedures exist to ensure that all claims are handled appropriately, with each member of staff having a specified handling authority. The processes include controls to avoid claims staff handling or paying claims beyond their authorities, as well as controls to avoid paying invalid claims. Loss adjustors are used to handle certain claims to conclusion.

Reinsurance risk

Reinsurance is used to protect the insurance results against the impact of major catastrophic events or unforeseen volumes of, or adverse trends in, large individual claims and to transfer risk that is outside the Groups current risk appetite.

The following types of reinsurance are used where appropriate:

- Excess of loss per individual risk reinsurance to protect against significantly large individual losses.
- Excess of loss catastrophe event reinsurance to protect against major events, for example, windstorms or floods.
- Quota share reinsurance to protect against unforeseen adverse trends, where the reinsurer takes an agreed percentage of premiums and claims.
- Other forms of reinsurance may be utilised according to need, subject to approval by senior management or the board as appropriate.

Reinsurance is only effective when the counterparty is financially secure. Before entering a contract with a new reinsurer, it must satisfy the Credit Risk Approval process that uses information derived internally and from security ratings agencies. Acceptable reinsurers are rated at A- or better unless specifically authorised by the RBS Insurance Group Board.

Reserving risk

Reserving risk relates to both premiums and claims. It is the risk that reserves are assessed incorrectly such that insufficient funds have been retained to pay or handle claims as the amounts fall due, both in relation to those claims which have already occurred (in relation to the claims reserves, including claims handling expense reserves) or will occur in future periods of insurance (in relation to the premium reserves).

a) Premium reserves

In respect of premium reserves, it is the Groups policy to ensure that the net unearned premium reserves and deferred acquisition costs are adequate to meet the expected cost of claims and associated expenses in relation to the exposure after the balance sheet date. To the extent that the unearned premium reserves and deferred acquisition costs are inadequate, a liability adequacy provision will be held which will initially write down any deferred acquisition asset held. Once any deferred acquisition asset has been exhausted, an additional liability adequacy provision will be established.

b) Claims reserves

It is the Groups policy to hold undiscounted claims reserves (including reserves to cover claims which have occurred but not been reported (IBNR reserves)) for all classes at a sufficient level to meet all liabilities as they fall

due, having regard to actuarial estimates and the volatility observed and expected in the claims in each class.

The Groups policy is to hold provisions for the major classes of business in excess of the actuarial best estimate. The percentage margin in excess of this estimate is assessed by senior management, with particular reference to the volatility observed and expected in the claims in each class.

The Groups 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.

Frequency and severity of specific risks and sources of uncertainty

Most general insurance contracts written by the Group are issued on an annual basis, which means that the Groups liability extends for a 12 month period, after which the Group is entitled to decline or renew or can impose renewal terms by amending the premium or excess or both.

The following paragraphs explain the frequency and severity of claims and the sources of uncertainty for the key classes that the Group is exposed to:

a) Motor insurance contracts (private and commercial)

Claims experience is quite variable, due to a wide number of factors, but the principal ones of these are age of driver, type of vehicle and use.

There are many sources of uncertainty that will impact the Group's experience under motor insurance, including operational risk, reserving risk, premium rates not matching claims inflation rates, the social, economic and legislative environment and reinsurance failure risks.

b) Property insurance contracts (residential and commercial)

The major causes of claims for property insurance are theft, flood, escape of water, fire, storm, subsidence and various types of accidental damage.

The major source of uncertainty in the Groups property accounts is the volatility of weather. Weather in the UK can affect most of the above perils. Over a longer period, the strength of the economy is also a factor. There are many other sources of uncertainty which include operational, reserving and reinsurance issues.

c) Commercial other insurance contracts

Other commercial claims come mainly from business interruption and loss arising from the negligence of the insured (liability insurance). Business interruption losses come from the loss of income, revenue and/or profit as a result of property damage claims. Liability insurance can be broken down between employers liability and public/products liability. The first is to indemnify employees for injury caused as a result of the insured�s negligence. Public/products liability is to indemnify a third party for injury and/or damage as a result of an act of the Insured�s negligence. As liability insurance is written on an occurrence basis, these covers are still subject to claims that manifest over a substantial period of time, but where loss was in existence during the life of the policy.

Fluctuations in the social, economic and legislative climate are a source of uncertainty in the Group�s general liability account, and in particular court judgements and legislation (for example periodic payments under the Courts Act, a review of the Ogden tables used by the courts when setting personal injury claim values), significant events (for example terrorist attacks) and any emerging new heads of damage, types of claim that are not envisaged when the policy is written.

d) Creditor insurance

Creditor insurance contracts are designed to cover payments on secured or unsecured lending. These contracts are for a maximum term of 5 years. The causes of creditor insurance claims are loss of income through accident, sickness or unemployment or, in some circumstances, loss of life.

The main source of uncertainty affecting the Group's creditor accounts is the economic environment. A recession could lead to an increased number and cost of unemployment, accident and sickness claims. Other sources of uncertainty include operational and reserving issues.

Life business

The three regulated life companies of RBSG, NatWest Life Assurance Limited, Royal Scottish Assurance plc and Direct Line Life Limited, are required to meet minimum capital requirements at all times under the Financial Service Authority�s Prudential Sourcebook. The capital resources covering the regulatory requirement are not transferable to other areas of the Group. To ensure that the capital requirement is satisfied at all times, each company holds an additional voluntary buffer above the absolute minimum. Sufficient capital resources are held to ensure that the capital requirements are covered over a two year projection period. Life insurance results are inherently uncertain, due to actual experience being different to modelled assumptions. Such differences affect regulatory capital resources, as do varying levels of new business. Therefore, projections are formally reviewed twice a year. Where there is a shortfall of capital, various options are available to provide new capital.

The Group is not exposed to price, currency, credit, or interest risk on unit linked life contracts but it is exposed to variation in management fees. A decrease of 10% in the value of the assets would reduce the asset management fees by £5 million per annum (2004 � £5 million). The Group also writes insurance contracts with minimum guaranteed death benefits that expose it to the risk that declines in the value of underlying investments may increase the Group�s net exposure to death risk.

Frequency and severity of claims � for contracts where death is the insured risk, the most significant factors that could increase the overall frequency of claims are epidemics or wide spread changes in lifestyle, resulting in earlier or more claims than expected.

For contracts where survival is the insured risk, the most significant factor is continued improvement in medical science and social conditions that would increase longevity.

For contracts with fixed and guaranteed benefits and fixed future premiums, there are no mitigating terms and conditions that reduce the insurance risk accepted. Participating contracts can result in a significant portion of the insurance risk being shared with the insured party.

Sources of uncertainty in the estimation of future benefit payments and premium receipts the Group uses base tables of standard mortality appropriate to the type of contract being written and the territory in which the insured person resides. These are adjusted to reflect the Groups experience, mortality improvements and voluntary termination behaviour.

Purchased insurance

The Insurance Sourcing Department is responsible to GEMC for the Group-wide purchase of insurance as a means of reducing other risk exposures.

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 within the organisation from:

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

Operating and financial review continued

External risk is defined as the risk arising 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 Groups activities.

Enterprise risk management is achieved through monitoring the Groups 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 trends and the risk profile of each division.

Regulatory risk

Regulatory risk is the risk arising from failing to meet the requirements of our regulators. To mitigate this risk, the Group is active in various regulatory developments affecting risk, capital and liquidity management. This includes working with domestic and international trade associations, being active with various regulators, especially the FSA and the main regulatory groups, including the Basel Committee (see page 208), the Committee of European Banking Supervisors, the EU Commission and US regulators.

Governance

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Board of directors and secretary*

*Not pictured: Johnny Cameron, Mark Fisher and Bill Friedrich (each appointed in March 2006)

Chairman
Sir George Mathewson (age 65)
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 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.

Deputy Chairman and
Chairman-designate
Sir Tom McKillop* (age 62)
C, N

Appointed to the Board as Deputy Chairman in September 2005, Sir Tom is a non-executive director of BP p.l.c., and was formerly chief executive of AstraZeneca plc. He was formerly president of the European Federation of Pharmaceutical Industries and Associations and chairman of the British Pharma Group. He is Pro-Chancellor of the University of Leicester and a trustee of the Council for Industry and Higher Education.

Executive directors
Sir Fred Goodwin (age 47)
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, a non-executive director of Bank of China Limited and a former president of the Chartered Institute of Bankers in Scotland.

Lawrence Fish (age 61)
Chairman 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 56)
FCIBS, FCIB
Chief Executive,
Retail Markets

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 also a director of Race for Opportunity and a member of the National Employment Panel and the FSA Practitioner Panel.

Guy Whittaker (age 49)
Group Finance Director
C

Appointed to the Board in February 2006, Guy Whittaker was formerly group treasurer at Citigroup Inc., based in New York, having previously held a number of management positions within the financial markets business at Citigroup. He was elected a Lady Beaufort Fellow of Christ's College Cambridge in 2004.

Johnny Cameron (age 51)
FCIBS
Chief Executive, Corporate Markets

Appointed to the Board in March 2006, Johnny Cameron has held a number of senior positions in financial institutions including County NatWest, Dresdner Kleinwort Benson and RBS. He was appointed Managing Director, Corporate and Institutional Banking in 1998, before being promoted to Deputy Chief Executive, Corporate Banking and Financial Markets (renamed Corporate Markets in January 2006) in 2000, and Chief Executive in 2001.

Mark Fisher (age 46)
FCIBS
Chief Executive, Manufacturing

Appointed to the Board in March 2006, Mark Fisher is a career banker, having joined the Group in 1981 as a graduate trainee. Mark has held a number of senior management positions in NatWest Retail Bank, including Finance Director and latterly Chief Operating Officer. He was responsible for overseeing the successful integration of NatWest on to the RBS operational platform following the acquisition in 2001, and has since then completed the integration of Churchill Insurance. Mark is also Chairman of The Association for Payment Clearing Services (APACS).

Non-executive directors
Colin Buchan* (age 51)
A, C, 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 chairman of UBS Securities Canada Inc. and vice-chairman of Standard Life Investments Limited. He is also a director of Merrill Lynch World Mining Trust Plc, Merrill Lynch Gold Limited, Royal Scottish National Orchestra Society Limited and World Mining Investment Company Limited.

Jim Currie* (age 64)
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 EUs environmental policy and director general for Customs and Excise and Indirect Taxation. He is also a director of Total Holdings UK Limited, an international advisor to Eversheds and a consultant to Butera & Andrews UK Limited.

Bill Friedrich* (age 56)

Appointed to the Board in March 2006, Bill Friedrich was appointed to the Board of BG Group plc as an Executive Director, Deputy Chief Executive and General Counsel in October 2000. Since 2005, he has had primary responsibility for the Group’s overall strategy function and portfolio development activities as well as oversight of the Group’s organisational and human resource matters. Prior to that he was responsible for BG’s operations in North and South America and various Group-wide staff functions. He joined British Gas plc in December 1995 as General Counsel after a 20-year career with Shearman & Sterling, based in New York, where he became a partner in 1983.

Archie Hunter* (age 62)
A (Chairman), C

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 1997/1998. 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 59)

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 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. He is also a director of Assurant, Inc.

Janis Kong* (age 55)
OBE, DUniv

Appointed to the Board in January 2006, Janis Kong is currently executive chairman of Heathrow Airport Limited, chairman of Heathrow Express Limited and a director of BAA plc and Portmeirion Group plc. She is also a member of the board of Visit Britain and previously served as a member of the board of the South East England Regional Development Agency.

Joe MacHale* (age 54)
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, a non-executive director of Brit Insurance Holdings 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.

Sir Steve Robson* (age 62)
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 JP Morgan Cazenove Holdings, Xstrata Plc and Partnerships UK plc, and a member of the Chairman’s Advisory Committee of KPMG.

Bob Scott* (age 64)
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. He 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 and a non-executive director of Swiss Reinsurance Company (Zurich), Jardine Lloyd Thompson Group plc and Focus DIY Group Limited. He is also a trustee of the Crimestoppers Trust and an adviser to Duke Street Capital.

Peter Sutherland* (age 59)
KCMG
C, 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 p.l.c. and Goldman Sachs International and honorary president and member of the Advisory Council for the European Movement Ireland. 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 56)

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 Chairmans 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 2005.

Profit and dividends

The profit attributable to the ordinary shareholders of the company for the year ended 31 December 2005 amounted to £5,392 million compared with £4,856 million for the year ended 31 December 2004, as set out in the consolidated income statement on page 97.

An interim dividend of 19.4p per ordinary share was paid on 7 October 2005 totalling £619 million (2004 – £529 million). The directors now recommend that a final dividend of 53.1p per ordinary share totalling £1,700 million (2004 – £1,308 million) be paid on 9 June 2006 to members on the register at the close of business on 10 March 2006. Subject to approval of the dividend at the Annual General Meeting, shareholders will be offered the opportunity to participate in a dividend reinvestment plan, which will replace the current scrip dividend scheme.

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 wide range of banking, insurance and other financial services. The financial risk management objectives and policies of the Group and information on the Group's exposure to price, credit, liquidity and cash flow risk are contained in Note 34 on the financial statements. Details of the principal subsidiary undertakings of the company are shown in Note 15. A review of the business for the year to 31 December 2005, of recent events and of likely future developments is contained in the Operating and financial review.

Business developments

In August 2005, the Group announced a strategic partnership with Bank of China (BoC). Subsequently, a Group-led consortium acquired a 10% shareholding in BoC through a majority-owned subsidiary for US$3.1 billion (£1.7 billion). The Group's share of the investment (US$1.6 billion) was financed through the disposal of its 2.2% holding in the issued share capital of Banco Santander Central Hispano, S.A. Following receipt of all required regulatory approvals, the investment was completed in December 2005. The two banks will co-operate across a range of business activities in China including credit cards, wealth management, corporate banking and personal lines insurance. They will also closely co-operate in key operational areas including financial controls, risk management, human resources and corporate governance.

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 2005, the ordinary share capital was increased by the following issues:

(a) 13.5 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 0.7 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;

(b) 7.4 million ordinary shares allotted in lieu of cash dividends; and

(c) 2.3 million ordinary shares allotted under the company's employee share ownership plan.

Details of the authorised and issued ordinary share capital at 31 December 2005 are shown in Note 30.

Preference share capital

Details of issues of preference shares during the year and the authorised and issued share capital at 31 December 2005 are shown in Note 30.

Authority to repurchase shares

At the Annual General Meeting in 2005, shareholders renewed the authority for the company to make market purchases of up to 317,495,924 ordinary shares. The directors have not exercised this authority to date. The Group has however announced its intention to repurchase up to £1 billion of ordinary shares over the course of the next 12 months, and shareholders will be asked to renew this authority at the Annual General Meeting in April.

Shareholdings

As at 27 February 2006, 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:		
Legal & General Group plc	98,761,695	3.40
Barclays PLC	126,816,644	3.97
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 s
5½% cumulative preference shares:	
Commercial Union Assurance plc	9
Mr P. S. and Mrs J. Allen	8
Bassett-Patrick Securities Limited*	4
E M Behrens Charitable Trust	2
Mrs Gina Wild	1
Trustees of The Stephen Cockburn Limited Pension Scheme	1
Miss Elizabeth Hill	1
Mr W. T. Hardison Jr.	1
Ms C. L. Allen	1
Ms J. C. Allen	1

* 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 5½ % 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:

- Sir Angus Grossart, Lord Vallance and Iain Robertson, who retired from the Board on 20 April 2005, and Eileen Mackay, who retired from the Board on 31 December 2005,
- Sir Tom McKillop, who was appointed to the Board on 1 September 2005, Janis Kong, who was appointed to the Board on 1 January 2006, and Guy Whittaker, who was appointed to the Board on 1 February 2006, and
- Fred Watt, who resigned from the Board on 31 January 2006,

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

Sir Tom McKillop, Colin Buchan, Janis Kong, Bob Scott, Peter Sutherland and Guy Whittaker will retire and offer themselves for election or re-election at the company’s Annual General Meeting. Bill Friedrich, Johnny Cameron and Mark Fisher have been appointed as directors with effect from 1 March 2006 and will also offer themselves for election at the company’s Annual General Meeting.

Details of the service agreement for Guy Whittaker are set out on page 77. Johnny Cameron has a service agreement with The Royal Bank of Scotland plc dated 29 March 1998 which may be terminated by Mr Cameron giving six months notice to the Royal Bank and by the Royal Bank giving 12 months notice to Mr Cameron. Mark Fisher has a service agreement with The Royal Bank of Scotland plc dated 3 May 2000 which may be terminated by either party giving six months notice to the other. No other director seeking election or re-election has a service agreement.

Sir George Mathewson will retire as Chairman of the Board with effect from the conclusion of the Annual General Meeting on 28 April 2006. The Group has secured his continued employment to serve in an advisory role to the Group. Sir Tom McKillop will succeed Sir George as Chairman.

Directors interests

The interests of the directors in the shares of the company at 31 December 2005 are shown on page 82. 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 2005 to 27 February 2006.

Employee proposition

The Group recognises that staff performance is central to the successful delivery of its overall business strategy. Accordingly, the Group focuses on maintaining an employee proposition that attracts, engages and retains the best available talent.

Employee recruitment

Utilising a wide range of recruitment channels, including an open internal jobs market, talent forums and detailed succession planning, the Group ensures that the recruitment and development of employees is closely aligned to organisational requirements. A strong standing as an employer of choice prompts applications from hundreds of thousands of potential candidates each year. Similarly, all vacancies are displayed internally and RBS employees can apply for any role.

The Group retains a high profile as a graduate recruiter, providing a wide range of development programmes. In 2005, more than 14,000 graduates applied for over 230 places with the Group. The Group also received the Association of Graduate Recruiters Award for delivering the Best Integrated Marketing Recruitment Campaign targeted at graduates.

Report of the directors continued

Group-wide co-ordination and access to recruitment and interview skills training ensures recruitment complies with internal and regulatory requirements. In addition, the Group continues to ensure all appointees are appropriately referenced and screened prior to joining the organisation.

Employee reward

The Group acknowledges that its continuing success is closely linked to the performance, skills and individual commitment of its employees. Significant focus is therefore given to offering an exceptional reward proposition to all RBS Group employees in order to attract, motivate and retain the best available talent at every level.

In 2005, employee costs of £5,992 million, including National Insurance and pension costs of £864 million, made up over a third of total expenditure.

The Groups remuneration and benefits package, Total Reward, (consisting of salary, bonus, share scheme and competitive pension benefits) is acknowledged as one of the most comprehensive and flexible packages in the financial services sector. Salary awards within the Group reflect individual performance, offering greater increases for high performers, as well as acknowledging market competitor movements.

RBSelect, the Groups benefits choice programme, forms part of the Total Reward package. It provides for UK staff in the Group a flexible way of tailoring their reward to reflect their own individual lifestyle needs. Options range from subsidised childcare vouchers and discounted personal insurance products to environmentally friendly bicycle purchases.

Employees can also participate in bonus incentive plans specific to their business and share in the Groups ongoing 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 seven years this has amounted to a further 10 percent of basic salary.

To enable employees to get the most from Total Reward, a wide range of information about reward and benefits has been introduced through RBSpeople.com, an internet site offering 24 hour access from home or work.

The RBS group Charity Lottery was launched during 2005. Employees contributing to the prize fund through a small monthly entry fee have the chance to win up to 50% of the total funds collected each month. The remainder, after payment of a small lottery-operating fee, is donated to charity.

The Group continues to offer membership of its final pension scheme, with the entire cost being met by the Group. The largest scheme is the Royal Bank of Scotland Group Pension Fund, with 80,000 employee members in the UK.

Employee learning and development

The Group actively encourages learning and development and is committed to creating and providing opportunities both inside and outside the workplace. These experiences are provided through a variety of developmental initiatives, technological innovations and learning networks and forums. Creating and maintaining a talented network of people across the Group ensures not only a strong leadership capability, but also a high performing workforce.

In 2005 a new Group-wide approach to leadership development was launched. Called the Leadership Journey, it defines success at different leadership levels and the key developmental challenges that employees face as they progress within the Group. A suite of development programmes has been designed and implemented to ensure appropriate leadership development, supporting the challenges that individual leaders face whilst completing different stages of the Leadership Journey.

A core component of this ongoing activity is the Groups 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 opened in January 2006. The Business School is central to the Groups commitment to developing its leaders, and equipping them with the skills and confidence necessary to lead in complex and challenging environments.

Employee communication

Employee engagement is encouraged through a variety of means including a corporate intranet, Group and divisional magazines, team meetings led by line managers, briefings held by senior managers and regular dialogue with employees and employee representatives.

During 2005, the high quality of the Groups internal communications was reflected by success in a number of prestigious external awards schemes. Awards were attained at both Group and divisional level and included a Gold Award for hub magazine, the Manufacturing divisions internal publication, at the UK Communicators in Business Awards, and a Gold Award for the Group Communications team in the Regular Communications category at the International Visual Communication Association Awards

The Group Chief Executive and other senior Group executives regularly communicate with employees through Question Time style programmes, broadcast on the Groups internal television network. An Open Air debate chaired by the Group Chief Executive on Diversity and Inclusion, seeking to ensure equality of opportunity for employees and customers, typifies this approach.

Employee consultation

The Group's confidential global Employee Opinion Survey is externally designed, undertaken and analysed annually on behalf of the Group by International Survey Research ('ISR').

The survey enables employees to maximise their contribution to the Group by expressing their views and opinions on a range of key issues.

The results from the 2005 survey, which 86% of Group employees completed, demonstrated significant improvements for the fifth successive year. This year, for the very first time, the Group scored above the ISR Global Financial Services Norm in every single category.

The survey results are presented at Board, divisional and team levels. Action plans are developed to address any issues identified. With continuing year-on-year improvement, strong divisional results and improvements in all leading indicators, it is believed that results are sustainable, particularly given the Group's focus on continuous improvement.

In addition to direct communication and consultation with employees, the Group recognises the trade union Amicus in the UK, and the Irish Bank Officials Association and the Services, Industrial, Professional and Technical Union in Ireland. These formal relationships are complemented by works council arrangements in many of the Group's mainland Europe-based operations.

The Group has an European Employee Communication Council that provides elected employee representatives with an opportunity to better understand market conditions and strategic decisions with transnational impact on our European operations.

Diversity

The Group's 'Managing Diversity' policy sets a framework and a minimum standard within which all employees can develop to their full potential irrespective of race, gender, marital status, age, disability, religious belief, political opinion or sexual orientation. Each division has developed and delivered an action plan incorporating both Group and division-specific priorities to promote diversity across all areas of the employee lifecycle.

The success of this approach culminated in the Group receiving a Gold Standard Award in the Race for Opportunity Benchmarking Survey, having previously attained a Bronze in 2004. The Group maintains its involvement in and support of the UK Employers' Forum on Age, Employers' Forum on Disability, Employers' Forum on Belief, Stonewall and of the Government's Age Positive campaign.

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

Health, safety, wellbeing and security

The health, safety, wellbeing and security of RBS staff and customers continue to be a priority for the Group. Regular reviews are undertaken of both policies and processes to ensure compliance with current legislation and best practice. The Group focus is on ensuring that these 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 twice each year. Further details of the Group's corporate responsibility policies will be contained in the 2005 Corporate Responsibility Report.

Code of ethics

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

Charitable contributions

In 2005 the contribution to the Group's Community Investment programmes increased to £56.2 million (2004 – £45.8 million). The total amount given for charitable purposes by the company and its subsidiary undertakings during the year ended 31 December 2005 was £24.3 million (2004 – £20.1 million).

Corporate governance

The company is committed to high standards of Corporate governance. Details are given on pages 67 to 72.

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 Group's longstanding policy of not making contributions to any political party be changed. A resolution to renew a general Group authority will be proposed at the Annual General Meeting on 28 April 2006.

Report of the directors continued

Policy and practice on payment of creditors

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

At 31 December 2005, the Group's trade creditors represented 27 days (2004 – 27 days) of amounts invoiced by suppliers. The company does not have any trade creditors.

Directors' indemnities

In terms of section 309C of The Companies Act 1985 (as amended), the directors of the company, members of the Group Executive Management Committee and Approved Persons of the Group (under the Financial Services and Markets Act 2000) have been granted Qualifying Third Party Indemnity Provisions by the company.

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
27 February 2006

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 2005, 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 currently applicable sections of the Act.

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 by 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 the financial and risk management of the company. Meetings of the Board are structured to allow open discussion.

The Board met nine times during 2005 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 at meetings of the Board.

Board balance and independence

The Board currently comprises the Chairman, six executive directors and eleven 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 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.

The Board currently comprises ten independent and seven non-independent directors (including executive directors), in addition to the Chairman. Sir Tom McKillop is Chairman-designate and 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 exception of Bud Koch who was formerly Chairman, President and Chief Executive Officer of Charter One Financial, Inc. which was acquired by Citizens Financial Group, Inc. in 2004.

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 2006 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.

Corporate governance continued

Performance evaluation

The annual performance evaluation of the Board and its Committees was undertaken in the autumn of 2005. The evaluation, which covered the operation and effectiveness of the Board, the Remuneration Committee and the Nominations Committee, was conducted by the Group Secretary using a detailed questionnaire and meetings with each director. Amongst the areas reviewed were the composition of the Board, Board processes and performance against objectives.

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 review of the effectiveness of the Audit Committee was undertaken during the year by PricewaterhouseCoopers and was the subject of a separate report to the Board. Amongst the areas reviewed were the composition and performance of the Committee and the Committee's role in relation to internal and external audit, risk management and financial reporting.

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.

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.

Audit Committee

All members of the Audit Committee are independent non-executive directors. The Audit Committee holds at least five meetings each year. The Audit Committee's report is contained on pages 71 and 72.

Remuneration Committee

All members of the Remuneration Committee are independent non-executive directors. The Remuneration Committee holds at least 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 73 to 81.

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 Nominations 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 to, and the 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 are anticipated to 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 2005	9	9	5	5
Number of meetings attended in 2005				
Sir George Mathewson	9	—	—	5
Sir Tom McKillop*	2	—	—	2
Lord Vallance**	4	—	—	—
Sir Angus Grossart**	4	—	—	—
Sir Fred Goodwin	9	—	—	—
Mr Buchan	9	8	5	—
Dr Currie	9	—	5	—
Mr Fish	6	—	—	—
Mr Hunter	9	9	—	—
Mr Koch	9	—	—	—
Mr MacHale	9	9	—	—
Miss Mackay	9	9	5	—
Mr Pell	9	—	—	—
Mr Robertson**	3	—	—	—
Sir Steve Robson	9	9	—	—
Mr Scott	9	—	5	4
Mr Sutherland	8	—	—	4

Mr Watt	9			

* Sir Tom McKillop was appointed to the Board on 1 September 2005.

** Lord Vallance, Sir Angus Grossart and Iain Robertson retired from the Board on 20 April 2005.

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 companys largest institutional shareholders is undertaken as part of the companys investor relations programme. During the year, the directors received copies of analysts reports and a monthly report from the Groups investor relations department which includes an analysis of share price movements, the Groups performance against the sector, and key broker comments. In addition, information on major investor relations activities and changes to external ratings are provided. In 2005, the senior independent director attended results presentations to enhance his understanding of the views of major shareholders and would be available to shareholders if concerns could not be addressed through the normal channels. The arrangements 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.

In 2005, a survey of investor perceptions was undertaken on behalf of the Board by independent advisers, and the findings were considered by the Board.

Internal control

The Board of directors is responsible for the Groups 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 2005 and to 27 February 2006, 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 Groups internal control system is reviewed regularly by the Board and the Audit Committee. Executive management committees or boards of directors in each of the Groups 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 Groups approach to risk management are given in the Risk management section of the Operating and financial review on pages 38 to 58. The Audit Committee also receives regular reports from Group Risk Management and Group Internal Audit. In addition, the Groups 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 is also subject to regulatory oversight in the UK and overseas. Additional details of the Groups regulatory oversight are given in the Supervision and Regulation section on pages 205 to 208.

Corporate governance continued

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 of 1934). 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 2005, 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, the company's internal control over financial reporting.

Audit Committee Report

The members of the Audit Committee are Archie Hunter (Chairman), Colin Buchan, Joe MacHale, Eileen Mackay, until her retirement on 31 December 2005, and Sir Steve Robson. All members of the Audit Committee are independent non-executive directors. The Audit Committee holds at least five meetings each year, two of which are held immediately prior to submission of the interim and annual financial statements to the Group Board. This core agenda is supplemented by additional meetings as required, four being added in 2005. Audit Committee meetings are attended by relevant executive directors, the internal and external auditors and risk management executives. At least twice per annum the Committee meets privately with the external auditors. The Audit Committee also visits business divisions and certain Group functions under a programme set at the beginning of each year.

The Board is satisfied that all 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" and is independent, each as defined in the SEC rules under the US Securities Exchange Act of 1934 and related guidance, 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 in making all relevant disclosures in relation to the financial affairs of the Group;
- reviewing accounting and financial reporting and regulatory compliance;
- reviewing the Group's systems of internal control; and
- monitoring the Group's processes for internal audit, risk management and external audit.

Full details of the responsibilities of the Audit Committee are available at www.rbs.com/content/corporate_responsibility/corporate_governance/downloads/group_audit.pdf.

The Audit Committee has adopted a policy on the engagement of the external auditors to supply audit and non-audit services, which takes into account relevant legislation regarding the provision of such services by an external audit firm. The Audit Committee reviews the policy annually and prospectively approves the provision of audit services and certain non-audit services by the external auditors.

Annual audit services include all services detailed in the annual engagement letter including the annual audit and interim reviews (including US reporting requirements), periodic profit verifications and reports to regulators including skilled persons reports commissioned by the Financial Services Authority (e.g. Reporting Accountants Reports).

Annual audit services also include statutory or non-statutory audits required by any Group companies that are not incorporated in the United Kingdom. Terms of engagement for these audits are agreed separately with management, and are consistent with those set out in the audit engagement letter, as local regulations permit.

The prospectively approved non-audit services include the following classes of service:

- capital raising, including consents, comfort letters and relevant reviews of registration statements;
- provision of accounting opinions relating to the financial statements of the Group;
- provision of reports that, according to law or regulation, must be rendered by the external auditors;
- tax compliance services;
- corporate finance services relative to companies that will remain outside the Group; and
- insolvency work relating to the Groups customers.

The Audit Committee approves all other permitted non-audit services on a case by case basis. The relevant submissions by management outline the service required and confirm that the external auditors independence will not be compromised. 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.

Information on the audit and non-audit services carried out by the external auditors is detailed in Note 4 to the Groups accounts.

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

The Audit Committee makes recommendations to the Board for it to put to the Shareholders for their approval at the Annual General Meeting, in relation to the appointment, re-appointment and removal of Deloitte & Touche LLP as the external auditors and to approve the remuneration and terms of engagement of the external auditors.

Corporate governance continued

In 2004 KPMG conducted a review of the effectiveness of Group Internal Audit. It is intended that there will be an external review of the effectiveness of Group Internal Audit every three years, with internal reviews continuing in the intervening years. In 2005 the Audit Committee conducted a review of Group Internal Audit that involved cross Group participation and the external auditors.

During 2005 PricewaterhouseCoopers conducted an external review of the effectiveness of the Audit Committee. It is intended that there will be an external review of the effectiveness of the Audit Committee every three years, with internal reviews by the Board continuing in the intervening years.

In 2005 the Audit Committee reviewed the audit committee structure throughout the Group and as a result proposed to the Board a reorganisation and strengthening of the structure to ensure that audit committees would cover each separate Group business appropriately. That recommendation was accepted by the Board and is now being implemented.

Directors remuneration report

The Remuneration Committee

The members of the Remuneration Committee are Bob Scott (Chairman), Colin Buchan, Jim Currie and Eileen Mackay, until her retirement on 31 December 2005. All members of the Remuneration Committee are independent non-executive directors.

During the accounting period, the Remuneration Committee received advice from Watson Wyatt, Mercer Human Resource Consulting and Ernst & Young LLP on matters relating to directors remuneration in the UK (Watson Wyatt and Ernst & Young) and US (Mercer). In addition, the Remuneration Committee has taken account of the views of the Chairman of the Board and the Group Chief Executive on performance assessment of the executive directors.

In addition to advising the Remuneration Committee, Watson Wyatt provided professional services in the ordinary course of business, including actuarial advice and benefits administration services to subsidiaries of the Group and investment consulting advice to The Royal Bank of Scotland Pension Trustees Limited. Mercer Human Resource Consulting provided advice and support in connection with a range of benefits, pension actuarial and investment matters. Ernst & Young provided professional services in the ordinary course of business, including actuarial and corporate recovery advice.

Remuneration policy

The executive remuneration policy was approved by shareholders at the companys Annual General Meeting in 2005. At the beginning of 2005, the Remuneration Committee decided to conduct a comprehensive review of all aspects of the executive remuneration package. A review of this depth had not been undertaken since 2000/2001. Its terms of reference were to examine all aspects of the executive remuneration strategy, policy and practice in light of the changing business make up and strategy of the Group and the evolution of best practice on executive remuneration. Following this review, the Remuneration Committee made no change to the overall executive remuneration policy, which is set out below. However, as a result of this review, the Group is making a number of changes to executive director remuneration practice which are described below.

The objective of the executive remuneration policy is to provide, in the context of the companys 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 directors 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. See illustrative charts below.
- Incentive plans and performance metrics will be structured to be robust through the business cycle.
- Remuneration arrangements will be designed to support the companys business strategy, to promote appropriate teamwork and to conform to best practice standards.

The above diagram has been prepared to illustrate the use of performance metrics in the total compensation package. For the Group Chief Executive 22% of the package is fixed and 78% is performance related. For the other executive directors, 28% is fixed and 72% is performance related. Values are entered on the basis of on target performance; long term incentives are shown at the approximate expected value at grant. Pension and other benefits have been excluded. Financial metrics include profit growth, cost control and ROE.

The non-executive directors fees are reviewed annually by the Board, on the recommendation of its 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).

Directors remuneration report continued

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 81.

From April 2006, new tax legislation will apply to UK pensions; in particular any pension in excess of the Lifetime Allowance will be subject to additional taxation. The Group will allow directors and employees whose benefits do, or are likely to exceed the Lifetime Allowance to opt-out of future tax-approved pension provision. In such cases the Group will pay the individual a salary supplement in lieu of pension provision. The Group will not meet the cost of any additional tax that individuals may incur as a result of their benefits exceeding the new Lifetime or Annual Allowances.

Executive directors are eligible to receive a choice of various employee benefits or a cash equivalent, on a similar basis to other employees. In addition, as 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 Groups 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

As part of the overall review of the executive remuneration package referred to above, short term incentive levels were considered and the Remuneration Committee agreed to increase annual incentive potentials to reflect market practice and the setting of stretching new targets. As a result, from 2006 individual UK-based executive directors will normally have a maximum annual incentive potential of between 160% and 200% of salary. These will 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.

For the Group Chief Executive, the annual incentive is primarily based on specific Group financial performance measures such as operating profit, earnings per share growth and return on equity. The remainder of the Group Chief Executives annual incentive is based on a range of non-financial measures which may include measures relating to shareholders, customers and staff.

For the other executive directors a proportion of the annual incentive is based on Group financial performance and a proportion on division financial performance. The remainder of each individuals annual incentive opportunity is dependent on achievement of a range of non-financial measures, specific objectives and key result areas. Divisional performance includes measures such as operating income, costs, bad debts or operating profit. Non-financial measures include customer measures (e.g. customer numbers, customer satisfaction), staff measures (e.g. employee engagement) and efficiency and change objectives.

For exceptional performance, as measured by the achievement of significant objectives, executive directors may be awarded incentive payments of up to 200% of salary, or 250% of salary, in the case of the Group Chief Executive. This discretion to pay additional bonuses for exceptional performance was last used in 2002 to recognise the successful integration of Natwest.

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.

The Groups policy is to encourage executives to hold shares and retain vested long-term incentives. This policy has successfully built high levels of shareholdings and equity participation amongst executives. A table showing directors interests in shares and the estimated value of the shares and vested long term incentives held by executives is shown on page 82. In light of the already high levels of share price exposure, the Remuneration Committee is not proposing to introduce mandatory or guideline shareholding requirements for executives at this

time.

Medium-term performance plan

The medium-term performance plan ("MPP") 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 awards over shares worth 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 to executive directors, 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. All awards under the plan are subject to three-year performance targets.

The award in 2005 is subject to two performance measures. 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 companies. The companies are Aviva plc; Banco Santander Central Hispano S.A. ("BSCH"); Barclays PLC; Citigroup inc.; HBOS plc; HSBC Holdings PLC; Legal & General Group plc; Lloyds TSB Group plc; Prudential plc and Standard Chartered PLC. Awards made 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% of the award, increasing to 200% if the company achieves a TSR ranking at first position in the comparator group and exceeds the TSR of the second placed comparator company by at least 34%.

During 2005, the Remuneration Committee reviewed all elements of the plan including the performance conditions, the vesting schedule and the comparator group. As a result, it is intended that for awards made from 2006, 50% of the award will vest on a relative TSR measure and 50% will vest on growth in adjusted EPS over the three year performance period.

The introduction of the EPS element is designed to ensure that the plan includes a performance measure which is in the clear line of sight for the participants and which reflects the business strategy for the next few years.

For the TSR element, vesting will be based on the level of outperformance by the Group of the median of the comparator group TSR over the performance period. The Remuneration Committee believes this method of measuring relative TSR performance provides a more approriate measure of management performance. This change is permitted under the rules of the plan. Awards made under the plan will not vest if the company’s TSR is below the median of the comparator group. Achievement of median TSR performance against comparator companies will result in vesting of 25% of the award. Outperformance of median TSR performance by up to 9% will result in vesting on a straight-line basis from 25% to 125%, outperformance by 9% to 18% will result in vesting on a straight-line basis from 125% to 200%. Vesting at 200% will occur if the company outperforms the median TSR performance of the comparator group by at least 18%.

Following the Remuneration Committee’s review of the plan, the comparator group was amended to comprise UK and international banking groups, which the Remuneration Committee considers more appropriate in the context of the Group’s business and performance. For awards made from 2006, the companies in the comparator group will be ABN Amro Holdings N.V.; BSCH; Barclays PLC; Citigroup Inc; HBOS plc; HSBC Holdings plc; Lloyds TSB Group plc and Standard Chartered PLC.

For the EPS element, the level of EPS growth over the three year period will be calculated by comparing the adjusted EPS in the year prior to the year of grant with that in the final year of the performance period. Each year the vesting schedule for the EPS growth measure will be agreed by the Remuneration Committee at the time of grant, having regard to the business plan, performance relative to comparators and analysts’ forecasts.

Options

The executive share option scheme was approved by shareholders in January 1999. The operation of the scheme was reviewed as part of the overall executive remuneration review and the Remuneration Committee is satisfied that no changes are required. Each executive director is eligible for an annual grant of an option, exercisable at the market price at the time of grant. Options granted to executive directors are typically over shares worth 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. No payment is made by the executive director on the grant of an option award.

All executive share option grants are subject to a performance condition which is reviewed by the Remuneration Committee annually. The performance target is currently that the options are exercisable only if, over a three year period from the date of grant, 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 from 2004, there is no re-testing of the performance condition.

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. A new cash long-term incentive plan was approved by shareholders at the 2005 Annual General Meeting. The remuneration policy for Mr Fish is as follows:

Base salary is 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.

Benefits Mr Fish accrues pension benefits under a number of arrangements in the US. Details are provided on page 81. In addition he is entitled to receive other benefits on a similar basis to other Citizens employees.

Short term performance rewards 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 is two times salary, although additional amounts to a maximum of a further 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 consist of the following components:

- The two grants made under the Citizens Phantom 2000 Plan vested 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 is 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 are set on an annual basis over the three year term of the grant.

Directors remuneration report continued

Total shareholder return performance

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 2000.

Total shareholder return

Service contracts

The companys 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. 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. Those contracts will normally include standard clauses covering the performance review process, the companys normal disciplinary procedure, and terms for dismissal in the event of failure to perform or in situations involving actions in breach of the Groups 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 Pell	20 February 2006 The Royal Bank of Scotland 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

* Mr Watt resigned as a director on 31 January 2006.

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 subject to the rules of relevant plan. The exception to these severance arrangements relates only to Mr Fish.

If Mr Fishs 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 has been advised that these termination provisions are less generous than the current market practice in the US.

Group Finance Director Guy Whittaker

Guy Whittaker was appointed Group Finance Director on 1 February 2006 and has a service contract with The Royal Bank of Scotland plc dated 19 December 2005. This service contract provides for a normal retirement age of 60 and may be terminated by either party giving 12 months notice to the other.

In accordance with normal market practice, Mr Whittaker will be recompensed for the value of restricted stock and unvested options he forfeited on his departure from his previous employer. In this respect he will be provided with ordinary shares in The Royal Bank of Scotland Group plc worth £1,000,000 and restricted stock worth £1,450,000, the latter vesting in 3 tranches between 2007 and 2009. As Mr Whittaker forfeited his performance bonus from his previous employer, he received a cash payment of £1,195,181 and will receive restricted stock worth £962,785, the latter vesting in 4 tranches between 2007 and 2010. The provision of ordinary shares and the vesting of restricted stock is subject to certain conditions set out in Mr Whittakers service contract.

As Group Finance Director, Mr Whittaker will be eligible to receive short-term annual incentives and long-term incentives on the same basis as other UK-based executive directors.

Chairman and non-executive directors

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

	Date first appointed	Latest date for next re-election
Sir George Mathewson	1 September 1987	retires 28 April 2006
Sir Tom McKillop	1 September 2005	2006
Mr Buchan	1 June 2002	2006
Dr Currie	28 November 2001	2008
Mr Hunter	1 September 2004	2008
Mr Koch	29 September 2004	2008
Mrs Kong	1 January 2006	2006
Mr MacHale	1 September 2004	2008
Sir Steve Robson	25 July 2001	2008
Mr Scott	31 January 2001	2006
Mr Sutherland	31 January 2001	2006

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. The dates in the table above reflect the latest date for re-election. However, in 2007, at least one-third of the Board will retire by rotation as required by the company's articles of association. No compensation would be paid to the Chairman or to any non-executive director in the event of early termination.

The tables and explanatory notes on pages 78 to 80 report the remuneration of each director for the year ended 31 December 2005 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	2005 Total £000	2004 Total £000
Chairman					
Sir George Mathewson	579		28	607	581
Executive directors					
Sir Fred Goodwin	1,090	1,760	43	2,893	2,522
Mr Fish **	824	1,649	36	2,509	2,305
Mr Pell	751	825	10	1,586	1,403
Mr Watt	669	726	4	1,399	1,268

* includes 10% profit sharing

** Mr Fish is a non-executive director of Textron Inc. and retains the fees paid to him in this respect. For 2005, he received a remuneration package from Textron Inc. equivalent to approximately US$75,400.

Non-executive directors	Board fees £000	Board committee fees £000	2005 Total £000	2004 Total £000
Deputy Chairman				
Sir Tom McKillop (appointed 1 September 2005)	67		67	
Vice-chairmen				
Lord Vallance of Tummel (retired 20 April 2005)	33		33	100
Sir Angus Grossart (retired 20 April 2005)	33		33	100
Mr Buchan	55	54	109	100
Dr Currie	55	13	68	60
Mr Hunter	55	58	113	22
Mr Koch	55		55	12
Mr MacHale	55	25	80	22
Miss Mackay (retired 31 December 2005)	55	38	93	75
Mr Robertson (retired 20 April 2005)	33		33	100
Sir Steve Robson	55	25	80	65
Mr Scott*	100		100	73
Mr Sutherland	55	5	60	53

 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.

* Mr Scotts senior independent director fee covers all Board and Board Committee work including Chairmanship of the Remuneration Committee.

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 2005 are included in the table below:

			Options exercised in 2005			Options held at 31 December 2005	
	Options held at 1 January 2005	Options granted in 2005	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
		41,570			17.29	41,570	10.03.08 – 09.03.15
	330,045	41,570				371,615	
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
	43,700				17.18	43,700	14.08.04 – 13.08.11
	1,713		1,713	16.19	9.85	–	
	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
		159,051			17.29	159,051	10.03.08 – 09.03.15
		1,267			13.04	1,267	01.10.10 – 31.03.11*
	652,176	160,318	1,713			810,781	
Mr Fish	107,877				9.33	107,877	11.05.01 – 10.05.08
	150				12.40	150	09.08.03 – 08.08.06*
		37,603			17.29	37,603	10.03.08 – 09.03.15
	108,027	37,603				145,630	
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
		50,607			17.29	50,607	10.03.08 – 09.03.15

	204,933	50,607		255,540	
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
	36,400		17.18	36,400	14.08.04 – 13.08.11
	303,729			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
	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
		57,259	17.29	57,259	10.03.08 – 09.03.15
	201,301	57,259		258,560	

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

** Mr Robertson retired from the Board on 20 April 2005.

*** Mr Watt resigned from the Board on 31 January 2006.

The performance conditions for options granted in 2005 are detailed on page 75.

Directors' remuneration report continued

No options had their terms and conditions varied during the accounting period to 31 December 2005. 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 exercisable 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 2005 was £17.55 and the range during the year to 31 December 2005 was £15.22 to £18.33.

In the ten year period to 31 December 2005, awards made using new issue shares under the company's share plans represented 4.62% of the company's issued ordinary share capital, leaving an available dilution headroom of 5.38%.

Medium Term Performance Plan

	Scheme interests (share equivalents) at 1 January 2005	Awards granted in 2005	Market price on award £	Awards vested in 2005*	Awards exercised in 2005	Market price on exercise £	Share interest (share equivalents) at 31 December 2005	End of period for qualifying conditions to be fulfilled
Sir Fred Goodwin	93,040		16.35				93,040	vested 31.12.03
	33,855		18.59				33,855	vested 31.12.04
	78,398		17.22	Nil			–	vested 31.12.05
	86,506		17.34				86,506	31.12.06
		95,431	17.29				95,431	31.12.07
	291,799						308,832	
Mr Fish	35,274		17.34				35,274	31.12.06
		10,495	17.29				10,495	31.12.07
	35,274						45,769	
Mr Pell	22,026		16.35				22,026	vested 31.12.03
	22,570		18.59		22,570	17.87	–	vested 31.12.04
	35,715		17.22	Nil			–	vested 31.12.05
	37,774		17.34				37,774	31.12.06
		40,486	17.29				40,486	31.12.07
	118,085						100,286	
Mr Robertson**	77,533		16.35		77,533	17.05	–	vested 31.12.03

Mr Watt	18,877		18.59		18,877	vested 31.12.04
	30,488		17.22	Nil	–	vested 31.12.05
	34,603		17.34		34,603	31.12.06
		38,173	17.29		38,173	31.12.07
	83,968				91,653	

* Awards were granted on 12 June 2003. The vesting level was nil and these awards have now lapsed.

** The exercise of awards for Mr Robertson occurred after his retirement from the Group Board on 20 April 2005.

Note:

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 pages 74 and 75.

Phantom 2000 Plan

	Phantom 2000 units at 1 January 2005	Awards granted during year: Units awarded during year	Awards granted 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 2005
Mr Fish	1,000,000			01.01.04	US$7,670,900	–
	1,000,000			01.01.05		1,000,000
	2,000,000					1,000,000

No variation was made to any of the terms of the plan during the year. The performance measures are detailed on page 74.

Citizens Long Term Incentive Plan

	Interests at 1 January 2005	Awards granted during year	Benefits received during year
Mr Fish	LTIP* awards for the 3 year periods: 01.01.02 – 31.12.04 01.01.03 – 31.12.05 01.01.04 – 31.12.06	LTIP award for the 3 year period: 01.01.05 – 31.12.07	LTIP award for the 3 year period: 01.01.02 – 31.12.04 was US$1,025,394

* A new cash LTIP was approved by shareholders at the company's Annual General Meeting in April 2005. Details are given on page 75. This replaces the previous LTIP which provided for a target payment of 60% of average salary over the three year period and a maximum payment of 105% of average salary.

Directors pension arrangements

During the year, Sir Fred Goodwin, 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 was provided with additional pension benefits on a defined contribution basis and contributions made in the year are shown below.

No changes are proposed to the level or form of pension benefits for any of the current directors as a result of the changes in pension legislation which come into force in April 2006 although as stated above directors will be able to opt out of tax-approved pension provision if they wish and receive a salary supplement in lieu. In addition consideration will be given to funding a greater proportion of the benefits.

Of the total transfer value as at 31 December 2005 shown, 25% relates to benefits in funded pension schemes. 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 continued 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 US. 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 2004 Report and Accounts, disclosure of these benefits has been made in accordance with the United Kingdom Listing Authority Listing Rules and the Combined Code and with the Directors Remuneration Report Regulations 2002.

Defined benefit arrangements	Age at 31 December 2005	Accrued entitlement at 31 December 2005 000 p.a.	Additional pension earned during the year ended 31 December 2005 000 p.a.	Additional pension earned during the year ended 31 December 2005* 000 p.a.	Transfer value as at 31 December 2005 000	Transfer value as at 31 December 2004 000
Sir Fred Goodwin	47	£444	£63	£51	£5,119	£3,591
Mr Pell	55	£302	£55	£47	£5,092	£3,592
Mr Robertson	60	£37	£4	£3	£676	£565
Mr Watt	45	£9	£2	£2	£96	£62
Mr Fish	61	$1,384	$244	$244	$13,347	$10,046

* 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 Robertson continued to accrue pension during his service with the Group in 2005 after resignation as a director. The figures above include the pension accrued during this subsequent service.

(3) 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.

(4) No allowance is made in these transfer values for any enhanced benefits that may become payable on early retirement.

(5) The proportion of benefits represented by funded pension schemes for Sir Fred Goodwin, Gordon Pell and Lawrence Fish is 3%, 69% and 3% respectively. All benefits for Iain Robertson and Fred Watt are in funded pension schemes.

(6) Following Mr Pells appointment as Executive Chairman, Retail Markets, he was awarded enhanced pension benefits.

(7) In accordance with US market practice, Mr Fishs pensionable remuneration is limited to $4 million per annum.

Contributions and allowances paid in the year ended 31 December 2005 under defined contribution arrangements were:

	2005 000	2004 000
Mr Watt	£144	£128
Mr Fish	$139	$91

Directors interests in shares

	Shares beneficially owned at 1 January 2005 or date of appointment if later	31 December 2005					
		Shares owned beneficially	Vested MPP shares or share equivalents	Vested share options	Total		Value as at 31 December 2005 (2,3)
Chairman							
Sir George Mathewson	250,816	260,159		256,254	516,413	£	6,577,478
Executive directors							
Sir Fred Goodwin	64,960	66,762	126,895	433,488	627,145	£	6,530,847
Mr Fish	11,120	11,120		108,027	119,147	£	1,082,677
Mr Pell	582	582	22,026	107,916	130,524	£	906,381
Mr Watt	58,408	59,111	18,877	115,548	193,536	£	1,708,409

	Shares beneficially owned at 1 January 2005 or date of appointment if later	Shares beneficially owned at 31 December 2005
Non-executive directors		
Sir Tom McKillop		30,000
Mr Buchan	5,000	5,000
Dr Currie		556
Mr Hunter	1,500	3,500
Mr Koch	20,000	20,000
Mr MacHale	10,000	10,000
Mr Scott	2,448	4,448
Mr Sutherland		5,590

No other director had an interest in the companys ordinary shares during the year.

On both 9 January 2006 and 7 February 2006, 7 ordinary shares of 25p each were acquired by Sir Fred Goodwin under the Groups Buy As You Earn share scheme.

Notes:

(1) The numbers shown in this table are taken from the audited disclosures shown elsewhere in this Annual Report.

(2) The value is based on the share price at 31 December 2005, which was £17.55. During the year ended 31 December 2005 the share price ranged from £15.22 to £18.33.

(3) The notional value of the vested share options has been calculated on the in the money value.

As of 1 March 2006, Mr Cameron and Mr Fisher (who were each appointed to the Board in March 2006 and are thus not included in the above charts) held 1,827 and 3,924 ordinary shares of the company, respectively. In addition, below are tables that set forth certain information regarding the Share options held by Mr Cameron and Mr Fisher as of 1 March 2006 and awards made to Mr Cameron and Mr Fisher under the company s Medium Term Performance Plan as of 1 March 2006, respectively. For further information regarding the Medium Term Performance Plan, see pages 74 to 75.

	Options held at 1 March 2006	Option price	Exercise period
Mr Cameron	150	15.63	05.04.04 03.04.07
	1,865	9.85	01.10.07 31.03.08
	19,194	11.18	04.03.02 03.03.09
	38,411	7.81	29.03.03 28.03.10
	26,200	17.18	14.08.04 13.08.11
	31,800	18.18	14.03.05 13.03.12
	52,600	12.37	13.03.06 12.03.13*
	50,461	17.34	11.03.07 10.03.14*
	80,972	17.29	10.03.08 09.03.15*
	301,653		
Mr Fisher	283	13.07	01.10.06 31.03.07
	311	12.09	01.10.07 31.03.08
	145	13.04	01.10.08 31.03.09
	14,281	9.24	01.04.02 31.03.09
	33,291	7.81	29.03.03 28.03.10
	22,700	18.18	14.03.05 13.03.12
	40,500	12.37	13.03.06 12.03.13*
	39,648	17.34	11.03.07 10.03.14*
	60,729	17.29	10.03.08 09.03.15*
	1,501	17.18	14.08.04 13.08.11*
	20,299	17.18	14.08.04 13.08.11*
	233,688		

*Not yet vested as at 1 March 2006

Medium term performance plan

	Scheme interests at 1 March 2006	Option price	End of period for qualifying conditions to be fulfilled
Mr Cameron	55,824	Nil	Vested 31.12.03
	22,078	Nil	Vested 31.12.04
	40,370	Nil	31.12.06
	46,270	Nil	31.12.07
	164,542		

Mr Fisher	20,000	Nil	Vested 31.12.03
	8,000	Nil	Vested 31.12.04
	31,719	Nil	31.12.06
	34,703	Nil	31.12.07
	94,422		

Note: 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.

Preference shares

Mr Fish held 20,000 non-cumulative preference shares of US$0.01 each at 31 December 2005 (2004 20,000) and Mr Koch held 20,000 non-cumulative preference shares of US$0.01 each at 31 December 2005 (2004 nil). 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 companys 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 2005, at 1 January 2005 or date of appointment if later.

Statement of directors responsibilities

The Directors are required by Article 4 of the IAS Regulation (European Commission Regulation No 1606/2002) to prepare Group accounts, and as permitted by the Companies Act 1985 have elected to prepare Company accounts, for each financial year in accordance with International Financial Reporting Standards. They are responsible for preparing accounts that present fairly the financial position, financial performance, and cash flows of the Group and the Company. 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 Annual report and accounts complies 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
27 February 2006

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Financial statements

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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 2005 which comprise the accounting policies, the balance sheets as at 31 December 2005 and 2004, the consolidated income statement, the cash flow statements, the statements of recognised income and expense for each of the two years in the period ended 31 December 2005 and the related Notes 1 to 47. 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 companys directors are responsible for the preparation of the financial statements in accordance with applicable United Kingdom law and International Financial Reporting Standards (IFRS) as adopted for use in the European Union. They are also responsible for the preparation of the other information contained in the 2005 Annual Report 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 International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view in accordance with the relevant framework 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 and Article 4 of the IAS Regulation. 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 also report to you if, in our opinion, the company has not complied with any of the four directors remuneration disclosure requirements specified for our review by the Listing Rules of the Financial Services Authority. These comprise the amount of each element in the remuneration package and information on share options, details of long term incentive schemes, and money purchase and defined benefit schemes. We give a statement, to the extent possible, of details of any non-compliance.

We review whether the corporate governance statement reflects the companys 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 Boards statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Groups corporate governance procedures or its risk and control procedures.

We read the directors report and the other information contained in the 2005 Annual Report 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 International Standards on Auditing (UK and Ireland) 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. The Group is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. 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 purposes of expressing an opinion on the effectiveness of the

Group□s internal controls 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 Group financial statements give a true and fair view, in accordance with IFRS as adopted for use in the European Union, of the state of the Groups affairs as at 31 December 2005 and of its profit and cash flows for the year then ended;
- the company financial statements give a true and fair view, in accordance with IFRS as adopted for use in the European Union as applied in accordance with the requirements of the Companies Act 1985, of the state of affairs of the company as at 31 December 2005;
- 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 and Article 4 of the IAS Regulation.

Separate opinion in relation to IFRS

As explained in the Accounting policies, the Group in addition to complying with its legal obligation to comply with IFRS as adopted for use in the European Union, has also complied with the IFRS as issued by the International Accounting Standards Board. In our opinion the financial statements give a true and fair view, in accordance with IFRS, of the state of the Groups affairs as at 31 December 2005 and of its profit for the year then ended.

US opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Group as at 31 December 2005 and 2004 and the results of its operations and its cash flows for each of the two years in the period ended 31 December 2005 in conformity with IFRS.

IFRS vary in certain significant respects from accounting principles generally accepted in the United States of America. Information relating to the nature and effect of such differences is presented in Note 46 to the financial statements.

Deloitte & Touche LLP
Chartered Accountants and Registered Auditors
Edinburgh, United Kingdom
27 February 2006

Accounting policies

1. Adoption of International Financial Reporting Standards

The annual accounts have, for the first time, been prepared in accordance with International Financial Reporting Standards adopted by the International Accounting Standards Board (IASB), and interpretations issued by the International Financial Reporting Interpretations Committee of the IASB (together IFRS) as endorsed by the European Union (EU). The EU has not endorsed the complete text of IAS 39 Financial Instruments: Recognition and Measurement; it has relaxed some of the standards hedging requirements. The Group has not taken advantage of this relaxation and has adopted IAS 39 as issued by the IASB. The date of transition to IFRS for the Group and the company (The Royal Bank of Scotland Group plc) and the date of their opening IFRS balance sheets was 1 January 2004. The company accounts have been presented in accordance with the Companies Act 1985.

The main differences between IFRS and previously applied generally accepted accounting principles (UK GAAP) and the effect of implementing IFRS on the Group and company balance sheets and shareholders funds as at 1 January and 31 December 2004 are set out on pages 162 to 170.

On initial adoption of IFRS, the Group (and the company where relevant) applied the following exemptions from the requirements of IFRS and from their retrospective application as permitted by IFRS 1 First-time Adoption of International Financial Reporting Standards:

Business combinations the Group has applied IFRS 3 Business Combinations to business combinations that occurred on or after 1 January 2004. Business combinations before that date have not been restated. Under UK GAAP, goodwill arising on acquisitions after 1 October 1998 was capitalised and amortised over its estimated useful economic life. Goodwill arising on acquisitions before 1 October 1998 was deducted from equity. The carrying amount of goodwill in the Groups opening IFRS balance sheet was £13,131 million, its carrying value under UK GAAP as at 31 December 2003.

Fair value or revaluation as deemed cost under UK GAAP, the Groups freehold and long leasehold property occupied for its own use was recorded at valuation on the basis of existing use value. The Group has elected to use this valuation as at 31 December 2003 as deemed cost for its opening IFRS balance sheet. At this date, the carrying value under UK GAAP of freehold and long leasehold property occupied for own use was £2,391 million.

Compound financial instruments the Group has not separated compound instruments between liability and equity components, as required by IAS 32 Financial Instruments: Disclosure and Presentation, where the liability component was not outstanding at 1 January 2004. UK GAAP did not permit compound instruments to be separated between liability and equity components on issue.

Derecognition the Group has applied the derecognition requirements of IAS 39 to transactions occurring on or after 1 January 1992.

Share based payments IFRS 2 Share-based Payment has been applied to equity instruments granted after 7 November 2002.

Implementation of IAS 32, IAS 39 and IFRS 4 Insurance Contracts (incorporating the adoption of FRS 27 Life Assurance) as allowed by IFRS 1, the Group and the company implemented IAS 32, IAS 39 and IFRS 4 with effect from 1 January 2005 without restating the income statement, balance sheet and notes for 2004. The Group has adopted the Amendment to IAS 39 The Fair Value Option issued by the IASB in June 2005 also from 1 January 2005. The effect of implementing IAS 32, IAS 39 and IFRS 4 on the Group and company balance sheets and shareholders funds as at 1 January 2005 is set out on pages 171 to 172. In preparing the 2004 comparatives, UK GAAP principles then current have been applied to financial instruments. The main differences between UK GAAP and IFRS on financial instruments are summarised on pages 164 to 166.

IFRS 1 prohibits retrospective application of some aspects of IFRS:

Derecognition of financial assets and liabilities non-derivative financial assets and liabilities derecognised before 1 January 1992 (the date from which the derecognition requirements of IAS 39 have been implemented) under the Groups previous GAAP have not been recognised in its opening IFRS balance sheet.

Hedge accounting hedging relationships of a type that does not qualify for hedge accounting under IAS 39 are not reflected in the Groups opening IFRS balance sheet.

Discontinued operations and assets classified as held for sale the Group has applied IFRS 5 Non-current Assets Held for Sale and Discontinued Operations from 1 January 2005.

The Group has adopted the Amendment Actuarial Gains and Losses, Group Plans and Disclosures to IAS 19 Employee Benefits from 1 January 2004. Actuarial gains and losses are recognised in full as they occur outside profit or loss.

2. Accounting convention

The company is incorporated in the UK and registered in Scotland. The financial statements have been prepared on the historical cost basis except that the following assets and liabilities are stated at their fair value: derivative financial instruments, held-for-trading financial assets and financial liabilities, financial assets and financial liabilities that are designated as at fair value through profit or loss, available-for-sale financial assets and investment property. Recognised financial assets and financial liabilities in fair value hedges are adjusted for changes in fair value in respect of the risk that is hedged.

3. Basis of consolidation

The consolidated financial statements incorporate the financial statements of the company and entities (including certain special purpose entities) controlled by the Group (its subsidiaries). Control exists where the Group has the power to govern the financial and operating policies of the entity; generally conferred by holding a majority of voting rights. On acquisition of a subsidiary, its identifiable assets, liabilities and

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contingent liabilities are included in the consolidated accounts at their fair value. Any excess of the cost (the fair value of assets given, liabilities incurred or assumed and equity instruments issued by the Group plus any directly attributable costs) of an acquisition over the fair value of the net assets acquired is recognised as goodwill. The interest of minority shareholders is stated at their share of the fair value of the subsidiary's net assets.

The results of subsidiaries acquired are included in the consolidated income statement from the date control passes to the Group. The results of subsidiaries sold are included up until the Group ceases to control them.

All intra-group balances, transactions, income and expenses are eliminated on consolidation. The consolidated accounts are prepared using uniform accounting policies.

4. Revenue recognition

Interest income on financial assets that are classified as loans and receivables, available-for-sale or held-to-maturity and interest expense on financial liabilities other than those at fair value through profit or loss are determined using the effective interest rate method. The effective interest rate method is a method of calculating the amortised cost of a financial asset or financial liability (or group of financial assets or liabilities) and of allocating the interest income or interest expense over the expected life of the asset or liability. The effective interest rate is the rate that exactly discounts estimated future cash flows to the instrument's initial carrying amount. Calculation of the effective interest rate takes into account fees receivable, that are an integral part of the instrument's yield, premiums or discounts on acquisition or issue, early redemption fees and transaction costs. All contractual terms of a financial instrument are considered when estimating future cash flows.

Financial assets and financial liabilities held-for-trading or designated as at fair value through profit or loss are recorded at fair value. Changes in fair value are recognised in profit or loss together with dividends and interest receivable and payable.

Commitment and utilisation fees are determined as a percentage of the outstanding facility. If it is unlikely that a specific lending arrangement will be entered into, such fees are taken to profit or loss over the life of the facility otherwise they are deferred and included in the effective interest rate on the advance.

Fees in respect of services are recognised as the right to consideration accrues through the provision of the service to the customer. The arrangements are generally contractual and the cost of providing the service is incurred as the service is rendered. The price is usually fixed and always determinable. The application of this policy to significant fee types is outlined below.

Payment services: this comprises income received for payment services including cheques cashed, direct debits, Clearing House Automated Payments (the UK electronic settlement system) and BACS payments (the automated clearing house that processes direct debits and direct credits). These are generally charged on a per transaction basis. The income is earned when the payment or transaction occurs. 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 income statement as the service is performed.

Interchange received: as issuer, the Group receives a fee (interchange) each time a cardholder purchases goods and services. The Group also receives interchange fees from other card issuers for providing cash advances through its branch and Automated Teller Machine networks. These fees are accrued once the transaction has taken place.

An annual fee payable by a credit card holder is deferred and taken to profit or loss over the period of the service i.e. 12 months.

Insurance brokerage: this is made up of fees and commissions received from the agency sale of insurance. Commission on the sale of an insurance contract is earned at the inception of the policy as the insurance has been arranged and placed. However, provision is made where commission is refundable in the event of policy cancellation in line with estimated cancellations.

Investment management fees: fees charged for managing investments are recognised as revenue as the services are provided. Incremental costs that are directly attributable to securing an investment management contract are deferred and charged as expense as the related revenue is recognised.

Insurance premiums see note 11 below.

5. Pensions and other post-retirement benefits

The Group provides post-retirement benefits in the form of pensions and healthcare plans to eligible employees.

For defined benefit schemes, scheme liabilities are measured on an actuarial basis using the projected unit credit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the scheme liabilities. Scheme assets are measured at their fair value. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit). The current service cost and any past service costs together with the expected return on scheme assets less the unwinding of the discount on the scheme liabilities is charged to operating expenses. Actuarial gains and losses are recognised in full in the period in which they occur outside profit or loss and presented in the statement of recognised income and expense. Contributions to defined contribution pension schemes are recognised in the income statement when payable.

6. Intangible assets and goodwill

Intangible assets that are acquired by the Group are stated at cost less accumulated amortisation and impairment losses. Amortisation is charged to profit or loss using methods that best reflect the economic benefits over their estimated useful

Accounting policies continued

economic lives and is included in Depreciation and amortisation. The estimated useful economic lives are as follows:

Core deposit intangibles	7 years
Other acquired intangibles	5-10 years
Computer software	3-5 years

Expenditure on internally generated goodwill and brands is written-off as incurred. Acquired goodwill being the excess of the cost of an acquisition over the Groups interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the subsidiary, associate or joint venture acquired is initially recognised at cost and subsequently at cost less any accumulated impairment losses. Goodwill arising on the acquisition of subsidiaries and joint ventures is included in the balance sheet caption Intangible fixed assets and that on associates within their carrying amounts. The gain or loss on the disposal of a subsidiary, associate or joint venture includes the carrying value of any related goodwill.

7. Property, plant and equipment

Items of property, plant and equipment are stated at cost less accumulated depreciation (see below) and impairment losses. Where an item of property, plant and equipment comprises major components having different useful lives, they are accounted for separately. Property that is being constructed or developed for future use as investment property is classified as property, plant and equipment and stated at cost until construction or development is complete, at which time it is reclassified as investment property.

Depreciation is charged to profit or loss on a straight-line basis so as to write-off the depreciable amount of property, plant and equipment (including assets owned and let on operating leases (except investment property see note 20 below)) over their estimated useful lives. The depreciable amount is the cost of an asset less its residual value. Land is not depreciated. Estimated useful lives are as follows:

Freehold and long leasehold buildings	50 years
Short leaseholds	unexpired period of the lease
Property adaptation costs	10 to 15 years
Computer equipment	up to 5 years
Other equipment	4 to 15 years

8. Impairment of intangible assets and property, plant and equipment

At each reporting date, the Group assesses whether there is any indication that its intangible assets, or property, plant and equipment are impaired. If any such indication exists, the Group estimates the recoverable amount of the asset and the impairment loss if any. Goodwill is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired. If an asset does not generate cash flows that are independent from those of other assets or groups of assets, recoverable amount is determined for the cash-generating unit to which the asset belongs. The recoverable amount of an asset is the higher of its fair value less costs to sell and its value in use. Value in use is the present value of future cash flows from the asset or cash-generating unit discounted at a rate that reflects market interest rates adjusted for risks specific to the asset or cash generating unit that have not been reflected in the estimation of future cash flows. If the recoverable amount of an intangible or tangible asset is less than its carrying value, an impairment loss is recognised immediately in profit or loss and the carrying value of the asset reduced by the amount of the loss. A reversal of an impairment loss on intangible assets (excluding goodwill) or property, plant and equipment is recognised as it arises provided the increased carrying value does not exceed that which it would have been had no impairment loss been recognised. Impairment losses on goodwill are not reversed.

9. Foreign currencies

The Groups consolidated financial statements are presented in sterling which is the functional currency of the company.

Transactions in foreign currencies are translated into sterling at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into sterling at the rates of exchange ruling at the balance sheet date. Foreign exchange differences arising on translation are recognised in profit or loss except for differences arising on cash flow hedges and hedges of net investments in foreign operations. Non-monetary items denominated in foreign currencies that are stated at fair value are translated into sterling at foreign exchange rates ruling at the dates the values were determined. Translation differences arising on non-monetary items measured at fair value are recognised in profit or loss except for differences arising on available-for-sale non-monetary financial assets, for example equity shares, which are included in the available-for-sale reserve in equity unless the asset is the hedged item in a fair value hedge.

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into sterling at foreign exchange rates ruling at the balance sheet date. The revenues and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions. Foreign exchange differences arising on the translation of foreign operations are recognised directly in equity.

10. Leases

Contracts to lease assets are classified as finance leases if they transfer substantially all the risks and rewards of ownership of the asset to the customer. Other contracts to lease assets are classified as operating leases.

Finance lease receivables are stated in the balance sheet at the amount of the net investment in the lease being the minimum lease payments and any unguaranteed residual value discounted at the interest rate implicit in the lease. Finance lease income is allocated to accounting periods so as to give a constant periodic rate of return before tax on the net investment. Unguaranteed residual values are subject to regular review to identify potential impairment. If there has been a reduction in the estimated unguaranteed residual value, the income allocation is revised and any reduction in respect of amounts accrued is recognised immediately.

Rental income from operating leases is credited to the income statement on a receivable basis over the term of the lease. Operating lease assets are included within Property, plant and equipment and depreciated over their useful lives (see note 7 above).

11. Insurance

General insurance

General insurance comprises short-duration contracts 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.

Premiums from general insurance contracts 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, 24ths 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 of claims over and above unearned premiums 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 expensed over the period during which the premiums are earned. The principal acquisition costs so deferred are commissions payable, 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 and the related reinsurance are recognised in the accounting period in which the loss occurs. Provision is made for the full cost 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. The related reinsurance receivable is recognised at the same time.

Life assurance

The Groups long-term assurance contracts include whole-life term assurance, endowment assurance, flexible whole-life, pension and annuity contracts that are expected to remain in force for an extended period of time. Long-term assurance contracts under which the Group does not accept significant insurance risk are classified as financial instruments. The Group recognises the value of in-force long-term assurance contracts as an asset. Cash flows associated with in-force contracts and related assets, including reinsurance cash flows, are projected, using appropriate assumptions as to future mortality, persistency and levels of expenses and excluding the value of future investment margins, to estimate future surpluses attributable to the Group. These surpluses, discounted at a risk-adjusted rate, are recognised as a separate asset. Changes in the value of this asset, which is determined on a post-tax basis, are included in operating profit.

The Group has reinsurance treaties that transfer significant insurance risk. Liabilities for reinsured contracts are calculated gross of reinsurance and a separate reinsurance asset recorded.

Premiums on long-term insurance contracts are recognised as income when receivable. Claims on long term insurance contracts reflect the cost of all claims arising during the year, including claims handling costs. Claims are recognised when the Group becomes aware of the claim.

12. Taxation

Provision is made for taxation at current enacted rates on taxable profits, arising in income or in equity, taking into account relief for overseas taxation where appropriate. Deferred taxation is accounted for in full for all temporary differences between the carrying amount of an asset or liability for accounting purposes and its carrying amount for tax purposes, except in relation to overseas earnings where remittance is controlled by the Group, and

goodwill.

Deferred tax assets are only recognised to the extent that it is probable that they will be recovered.

13. Financial assets

Financial assets are classified into held-to-maturity investments; available-for-sale financial assets; held-for-trading; designated as at fair value through profit or loss; or loans and receivables.

Held-to-maturity investments a financial asset is classified as a held-to-maturity investment only if it has fixed or determinable payments, a fixed maturity and the Group has the positive intention and ability to hold to maturity. Held-to-maturity investments are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at amortised cost using the effective interest method (see note 4 above) less any impairment losses.

Held-for-trading a financial asset is classified as held-for-trading if it is acquired principally for the purpose of selling in the near term, or forms part of a portfolio of financial instruments that are managed together and for which there is evidence of short-term profit taking, or it is a derivative (not in a qualifying hedge relationship). Held-for-trading financial assets are recognised at fair value with transaction costs being recognised in profit or loss. Subsequently they are measured at fair value. Gains and losses on held-for-trading financial assets are recognised in profit or loss as they arise.

Designated as at fair value through profit or loss financial assets that the Group designates on initial recognition as being at fair value through profit or loss are recognised at fair value, with transaction costs being recognised in profit or loss and are subsequently measured at fair value. Gains and losses on financial assets that are designated as at fair value through profit or loss are recognised in profit or loss as they arise.

Financial assets may be designated as at fair value through profit or loss only if such designation (a) eliminates or significantly reduces a measurement or recognition inconsistency; or (b) applies to a group of financial assets, financial liabilities or both that the Group manages and

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evaluates on a fair value basis; or (c) relates to an instrument that contains an embedded derivative which is not evidently closely related to the host contract.

The principal category of financial assets designated as at fair value through profit or loss is policyholders assets underpinning insurance and investment contracts issued by the Group's life assurance businesses. Fair value designation significantly reduces the measurement inconsistency that would arise if these assets were classified as available-for-sale.

Loans and receivables non-derivative financial assets with fixed or determinable repayments that are not quoted in an active market are classified as loans and receivables except those that are classified as available-for-sale or as held-for-trading, or designated as at fair value through profit or loss. Loans and receivables are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at adjusted cost using the effective interest method (see note 4 above) less any impairment losses.

Available-for-sale financial assets that are not classified as held-to-maturity; held-for-trading; designated at fair value through profit or loss; or loans and receivables are classified as available-for-sale. Financial assets can be designated as available-for-sale on initial recognition. Available-for-sale financial assets are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at fair value. Impairment losses and exchange differences resulting from retranslating the amortised cost of currency monetary available-for-sale financial assets are recognised in profit or loss together with interest calculated using the effective interest rate (see note 4 above). Other changes in the fair value of available-for-sale financial assets are reported in a separate component of shareholders equity until disposal, when the cumulative gain or loss is recognised in profit or loss.

Regular way purchases of financial assets classified as loans and receivables are recognised on settlement date; all other regular way purchases are recognised on trade date.

Fair value for a net open position in a financial asset that is quoted in an active market is the current bid price times the number of units of the instrument held. Fair values for financial assets not quoted in an active market are determined using appropriate valuation techniques including discounting future cash flows, option pricing models and other methods that are consistent with accepted economic methodologies for pricing financial assets.

14. Impairment of financial assets

The Group assesses at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets classified as held-to-maturity, available-for-sale or loans and receivables is impaired. A financial asset or portfolio of financial assets is impaired and an impairment loss incurred if there is objective evidence that an event or events since initial recognition of the asset have adversely affected the amount or timing of future cash flows from the asset.

Financial assets carried at amortised cost if there is objective evidence that an impairment loss on a financial asset or group of financial assets classified as loans and receivables or as held-to-maturity investments has been incurred, the Group measures the amount of the loss as the difference between the carrying amount of the asset or group of assets and the present value of estimated future cash flows from the asset or group of assets discounted at the effective interest rate of the instrument at initial recognition. Impairment losses are assessed individually for financial assets that are individually significant and individually or collectively for assets that are not individually significant. In making collective assessment of impairment, financial assets are grouped into portfolios on the basis of similar risk characteristics. Future cash flows from these portfolios are estimated on the basis of the contractual cash flows and historical loss experience for assets with similar credit risk characteristics. Historical loss experience is adjusted, on the basis of current observable data, to reflect the effects of current conditions not affecting the period of historical experience.

Impairment losses are recognised in profit or loss and the carrying amount of the financial asset or group of financial assets reduced by establishing an allowance for impairment losses. If in a subsequent period the amount

of the impairment loss reduces and the reduction can be ascribed to an event after the impairment was recognised, the previously recognised loss is reversed by adjusting the allowance. Once an impairment loss has been recognised on a financial asset or group of financial assets, interest income is recognised on the carrying amount using the rate of interest at which estimated future cash flows were discounted in measuring impairment.

Financial assets carried at fair value when a decline in the fair value of a financial asset classified as available-for-sale has been recognised directly in equity and there is objective evidence that the asset is impaired, the cumulative loss is removed from equity and recognised in profit or loss. The loss is measured as the difference between the amortised cost of the financial asset and its current fair value. Impairment losses on available-for-sale equity instruments are not reversed through profit or loss, but those on available-for-sale debt instruments are reversed, if there is an increase in fair value that is objectively related to a subsequent event.

15. Financial liabilities

A financial liability is classified as held-for-trading if it is incurred principally for the purpose of selling in the near term, or forms part of a portfolio of financial instruments that are managed together and for which there is evidence of short-term profit taking, or it is a derivative (not in a qualifying hedge relationship). Held-for-trading financial liabilities are recognised at fair value with transaction costs being recognised in profit or loss. Subsequently they are measured at fair value. Gains and losses are recognised in profit or loss as they arise. Financial liabilities that the Group designates on initial recognition as being at fair value through profit or loss are recognised at fair value, with transaction costs being recognised in profit or loss and are subsequently measured at fair value. Gains and losses on financial liabilities that are designated as at fair value through profit or loss are recognised in profit or loss as they arise.

Financial liabilities may be designated as at fair value through profit or loss only if such designation (a) eliminates or significantly reduces a measurement or recognition inconsistency; or (b) applies to a group of financial assets, financial liabilities or both that the Group manages and evaluates on a fair value basis; or (c) relates to an instrument that contains an embedded derivative which is not evidently closely related to the host contract.

The principal categories of financial liabilities designated as at fair value through profit or loss are (a) structured liabilities issued by the Group: designation significantly reduces the measurement inconsistency between these liabilities and the related derivatives carried at fair value, and (b) investment contracts issued by the Group's life assurance businesses: fair value designation significantly reduces the measurement inconsistency that would arise if these liabilities were measured at amortised cost.

All other financial liabilities are measured at amortised cost using the effective interest method (see note 4 above).

Fair value for a net open position in a financial liability that is quoted in an active market is the current offer price times the number of units of the instrument held or issued. Fair values for financial liabilities not quoted in an active market are determined using appropriate valuation techniques including discounting future cash flows, option pricing models and other methods that are consistent with accepted economic methodologies for pricing financial liabilities.

16. Derecognition

A financial asset is derecognised when it has been transferred and the transfer qualifies for derecognition. A transfer requires that the Group either: (a) transfers the contractual rights to receive the asset's cash flows; or (b) retains the right to the asset's cash flows but assumes a contractual obligation to pay those cash flows to a third party. After a transfer, the Group assesses the extent to which it has retained the risks and rewards of ownership of the transferred asset. If substantially all the risks and rewards have been retained, the asset remains on the balance sheet. If substantially all of the risks and rewards have been transferred, the asset is derecognised. If substantially all the risks and rewards have been neither retained nor transferred, the Group assesses whether or not it has retained control of the asset. If it has not retained control, the asset is derecognised. Where the Group has retained control of the asset, it continues to recognise the asset to the extent of its continuing involvement.

A financial liability is removed from the balance sheet when the obligation is discharged, or cancelled, or expires.

17. Capital instruments

The Group classifies a financial instrument that it issues as a financial asset, financial liability or an equity instrument in accordance with the substance of the contractual arrangement. An instrument is classified as a liability if it is a contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities on potentially unfavourable terms. An instrument is classified as equity if it evidences a residual interest in the assets of the Group after the deduction of liabilities. The components of a compound financial instrument issued by the Group are classified and accounted for separately as financial assets, financial liabilities or equity as appropriate.

18. Derivatives and hedging

Derivative financial instruments are recognised initially, and subsequently measured, at fair value. Derivative fair values are determined from quoted prices in active markets where available. Where there is no active market for an instrument, fair value is derived from prices for the derivative's components using appropriate pricing or valuation models.

A derivative embedded in a contract is accounted for as stand-alone derivative if its economic characteristics are not closely related to the economic characteristics of the host contract; unless the entire contract is carried at fair value through profit or loss.

Gains and losses arising from changes in fair value of a derivative are recognised as they arise in profit or loss unless the derivative is the hedging instrument in a qualifying hedge. The Group enters into three types of hedge

relationship: hedges of changes in the fair value of a recognised asset or liability or firm commitment (fair value hedges); hedges of the variability in cash flows from a recognised asset or liability or a forecast transaction (cash flow hedges); and hedges of the net investment in a foreign entity.

Hedge relationships are formally documented at inception. The documentation includes identification of the hedged item and the hedging instrument, details the risk that is being hedged and the way in which effectiveness will be assessed at inception and during the period of the hedge. If the hedge is not highly effective in offsetting changes in fair values or cash flows attributable to the hedged risk, consistent with the documented risk management strategy, hedge accounting is discontinued.

Fair value hedge in a fair value hedge, the gain or loss on the hedging instrument is recognised in profit or loss. The gain or loss on the hedged item attributable to the hedged risk is recognised in profit or loss and adjusts the carrying amount of the hedged item. Hedge accounting is discontinued if the hedge no longer meets the criteria for hedge accounting or if the hedging instrument expires or is sold, terminated or exercised or if hedge designation is revoked. If the hedged item is one for which the effective interest rate method is used, any cumulative adjustment is amortised to profit or loss over the life of the hedged item using a recalculated effective interest rate.

Cash flow hedge where a derivative financial instrument is designated as a hedge of the variability in cash flows of a recognised asset or liability or a highly probable forecast transaction, the effective portion of the gain or loss on the hedging instrument is recognised directly in equity. The ineffective portion is recognised in profit or loss. When the forecast transaction results in the recognition of a financial asset or financial liability, the cumulative gain or loss is reclassified from equity in the same periods in which the asset or liability affects profit or loss. Otherwise the cumulative gain or loss is removed from equity and recognised in profit or loss at the same

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Accounting policies continued

time as the hedged transaction. Hedge accounting is discontinued if the hedge no longer meets the criteria for hedge accounting; if the hedging instrument expires or is sold, terminated or exercised; if the forecast transaction is no longer expected to occur; or if hedge designation is revoked. On the discontinuance of hedge accounting (except where a forecast transaction is no longer expected to occur), the cumulative unrealised gain or loss recognised in equity is recognised in profit or loss when the hedged cash flow occurs or, if the forecast transaction results in the recognition of a financial asset or financial liability, in the same periods during which the asset or liability affects profit or loss. Where a forecast transaction is no longer expected to occur, the cumulative unrealised gain or loss is recognised in profit or loss immediately.

Hedge of net investment in a foreign operation – where a foreign currency liability hedges a net investment in a foreign operation, the portion of foreign exchange differences arising on translation of the liability determined to be an effective hedge is recognised directly in equity. Any ineffective portion is recognised in profit or loss.

19. Share-based payments

The Group grants options over shares in The Royal Bank of Scotland Group plc to its employees under various share option schemes. The Group has applied IFRS 2 'Share-based Payment' to grants under these schemes after 7 November 2002 that had not vested on 1 January 2005. The expense for these transactions is measured based on the fair value on the date the options are granted. The fair value is estimated using valuation techniques which take into account the option's exercise price, its term, the risk free interest rate and the expected volatility of the market price of The Royal Bank of Scotland Group plc's shares. Vesting conditions are not taken into account when measuring fair value, but are reflected by adjusting the number of options included in the measurement of the transaction such that the amount recognised reflects the number that actually vest. The fair value is expensed on a straight-line basis over the vesting period.

20. Investment property

Investment property comprises freehold and leasehold properties that are held to earn rentals or for capital appreciation or both. It is not depreciated but is stated at fair value based on valuations by independent registered valuers. Fair value is based on current prices in an active market for similar properties in the same location and condition. Any gain or loss arising from a change in fair value is recognised in profit or loss. Rental income from investment property is recognised on a straight-line basis over the term of the lease. Lease incentives granted are recognised as an integral part of the total rental income.

21. Cash and cash equivalents

Cash and cash equivalents comprises cash and demand deposits with banks together with short-term highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risk of change in value.

22. Shares in Group entities

The company's investments in its subsidiaries are stated at cost less any impairment.

Critical accounting policies and key sources of estimation uncertainty

The reported results of the Group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. UK company law and IFRS require the directors, in preparing the Group's financial statements, to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent. In the absence of an applicable standard or interpretation, IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors', requires management to develop and apply an accounting policy that results in relevant and reliable information in the light of the requirements and guidance in IFRS dealing with similar and related issues and the IASB's Framework for the Preparation and Presentation of

Financial Statements.

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

Loan impairment provisions

The Group's loan impairment provisions are established to recognise incurred impairment losses in its portfolio of loans classified as loans and receivables and carried at amortised cost. A loan is impaired when there is objective evidence that events since the loan was granted have affected expected cash flows from the loan. The impairment loss is the difference between the carrying value of the loan and the present value of estimated future cash flows at the loan's original effective interest rate.

At 31 December 2005, gross loans and advances to customers totalled £421,110 million (2004 – £351,419 million) and customer loan impairment provisions amounted to £3,884 million (2004 – £4,168 million).

There are two components to the Group's loan impairment provisions: individual and collective.

Individual component – all impaired loans that exceed specific thresholds are individually assessed for impairment. Individually assessed loans principally comprise the Group's portfolio of commercial loans to medium and large businesses. Impairment losses are recognised as the difference between the carrying value of the loan and the discounted value of management's best estimate of future cash repayments and proceeds from any security held. These estimates take into account the customer's debt capacity and financial flexibility; the level and quality of its earnings; the amount and sources of cash flows; the industry in which the counterparty operates; and the realisable value of any security held. Estimating the quantum and timing of future recoveries involves significant judgement. The size of receipts will depend on the future performance of the borrower and the value of security, both of which will be affected by future economic conditions; additionally, collateral may not be readily marketable. The actual amount of future cash flows and the date they are received may differ from these

estimates and consequently actual losses incurred may differ from those recognised in these financial statements.

Collective component this is made up of two elements: loan impairment provisions for impaired loans that are below individual assessment thresholds (collective impaired loan provisions) and for loan losses that have been incurred but have not been separately identified at the balance sheet date (latent loss provisions). These 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 portfolios include credit card receivables and other personal advances including mortgages. The future credit quality of these portfolios is subject to uncertainties that could cause actual credit losses to differ materially from reported loan impairment provisions. These uncertainties include the economic environment, notably interest rates and their effect on customer spending, the unemployment level, payment behaviour and bankruptcy trends.

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). 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 income statement. The assumptions adopted for the Groups pension schemes are set out in Note 3 on the financial statements. The pension deficit recognised in the balance sheet at 31 December 2005 was £3,735 million (2004 £2,940 million).

Fair value

Financial instruments classified as held-for-trading or designated as at fair value through profit or loss and financial assets classified as available-for-sale are recognised in the financial statements at fair value. All derivatives are measured at fair value. In the balance sheet, financial assets carried at fair value are included within Treasury and other eligible bills, Loans and advances to banks, Loans and advances to customers, Debt securities and Equity shares as appropriate. Financial liabilities carried at fair value are included within the captions Deposits by banks, Customer accounts, Debt securities in issue and Subordinated liabilities. Derivative assets and Derivative liabilities are shown separately on the face of the balance sheets. Gains or losses arising from changes in fair value of financial instruments classified as held-for-trading or designated as at fair value through profit or loss are included in the income statement. Unrealised gains and losses on available-for-sale financial assets are recognised directly in equity unless an impairment loss is recognised. The carrying value of a financial asset or a financial liability carried at cost or amortised cost that is the hedged item in a qualifying hedge relationship is adjusted by the gain or loss attributable to the hedged risk.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Fair values are determined 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.

Financial assets carried at fair value include government, asset backed and corporate debt securities, reverse repos, loans, corporate equity shares and derivatives. Financial liabilities carried at fair value include deposits, repos, short positions in securities and debt securities issued. Fair value for a substantial proportion of these instruments is based on observable market prices or derived from observable market parameters. Where observable prices are not available, 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.

Details of financial instruments carried at fair value are given in Note 34 on the financial statements.

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. General insurance claims provisions amounted to £4,913 million at 31 December 2005 (2004 □ £4,504 million).

Provisions are determined by management based on experience of claims settled and on statistical models which require certain assumptions to be made regarding the

Accounting policies continued

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. The carrying value of goodwill as at 31 December 2005 was £18,823 million (2004 £18,032 million).

Goodwill is the excess of the cost of an acquisition over the fair value of its net assets. The determination of the fair value of assets and liabilities of businesses acquired requires the exercise of management judgement; for example those financial assets and liabilities for which there are no quoted prices, and those non-financial assets where valuations reflect estimates of market conditions such as property. Different fair values would result in changes to the goodwill arising and to the post-acquisition performance of the acquisition. Goodwill is not amortised but is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired.

For the purposes of impairment testing goodwill acquired in a business combination is allocated to each of the Groups cash-generating units or groups of cash-generating units expected to benefit from the combination. Goodwill impairment testing involves the comparison of the carrying value of a cash-generating unit or group of cash generating units with its recoverable amount. The recoverable amount is the higher of the unit's fair value and its value in use. Value in use is the present value of expected future cash flows from the cash-generating unit or group of cash-generating units. Fair value is the amount obtainable for the sale of the cash-generating unit in an arms length transaction between knowledgeable, willing parties.

Impairment testing inherently involves a number of judgmental areas: the preparation of cash flow forecasts for periods that are beyond the normal requirements of management reporting; the assessment of the discount rate appropriate to the business; estimation of the fair value of cash-generating units; and the valuation of the separable assets of each business whose goodwill is being reviewed.

Accounting developments

International Financial Reporting Standards

The International Accounting Standards Board (IASB) issued IFRS 7 Financial Instruments: Disclosures in August 2005. The standard replaces IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions and the disclosure provisions in IAS 32 Financial Instruments: Disclosure and Presentation. IFRS 7 requires disclosure of the significance of financial instruments for an entitys financial position and performance and of qualitative and quantitative information about exposure to risks arising from financial instruments. The standard is effective for annual periods beginning on or after 1 January 2007. Earlier application is encouraged.

At the same time the IASB issued an amendment Capital Disclosures to IAS 1 Presentation of Financial Statements. It requires disclosures about an entity's capital and the way it is managed. This amendment is also effective for annual periods beginning on or after 1 January 2007. Earlier application is encouraged.

The IASB has also issued three amendments to IAS 39 Financial Instruments: Recognition and Measurement. The first, Cash Flow Hedge Accounting of Forecast Intragroup Transactions, published in April 2005, amends IAS 39 to permit the foreign currency risk of a highly probable forecast intragroup transaction to qualify as a hedged item in consolidated financial statements. The amendment is effective for annual periods beginning on or after 1 January 2006.

The second, The Fair Value Option, published in June 2005, places conditions on the option in IAS 39 to designate on initial recognition a financial asset or financial liability as at fair value through profit or loss. The amendment is effective for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. The Group has adopted this amendment from 1 January 2005 (see accounting policies on page 88).

The third, Financial Guarantee Contracts, published in August 2005, amends IAS 39 and IFRS 4 Insurance Contracts. The amendments define a financial guarantee contract. They require such contracts to be recorded initially at fair value and subsequently at higher of the provision determined in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets and the amount initially recognised less amortisation. The amendments are effective for annual periods beginning on or after 1 January 2006.

In December 2005, the IASB issued amendments to IAS 21 The Effects of Changes in Foreign Exchange Rates to clarify that a monetary item can form part of the net investment in overseas operations regardless of the currency in which it is denominated and that the net investment in a foreign operation can include a loan from a fellow subsidiary. The amendments are effective immediately but have not been endorsed by the EU.

The Group is reviewing IFRS 7 and the amendments to IAS 1 and IAS 21 and those to IAS 39 that it has not implemented, to determine their effect on its financial reporting.

US GAAP

For a discussion of recent developments in US GAAP relevant to the Group, see Note 46 on the accounts.

Consolidated income statement

for the year ended 31 December 2005

	Note	2005 £m	2004 £m
Interest receivable		21,331	16,632
Interest payable		(11,413)	(7,561)
Net interest income		9,918	9,071
Fees and commissions receivable		6,750	6,473
Fees and commissions payable		(1,841)	(1,926)
Income from trading activities	1	2,343	1,988
Other operating income (excluding insurance premium income)		2,953	2,138
Insurance premium income		6,076	6,146
Reinsurers share		(297)	(499)
Non-interest income		15,984	14,320
Total income		25,902	23,391
Staff costs		5,992	5,188
Premises and equipment		1,313	1,177
Other administrative expenses		2,816	2,323
Depreciation and amortisation		1,825	1,674
Operating expenses	2	11,946	10,362
Profit before other operating charges		13,956	13,029
Insurance claims		4,413	4,565
Reinsurers share		(100)	(305)
Operating profit before impairment losses		9,643	8,769
Impairment losses		1,707	1,485
Operating profit before tax	4	7,936	7,284
Tax	5	2,378	1,995
Profit for the year		5,558	5,289
Profit attributable to:			
Minority interests		57	177
Preference shareholders	6	109	256
Ordinary shareholders		5,392	4,856

		5,558	5,289
Per 25p ordinary share:			
Basic earnings	9	169.4p	157.4p
Diluted earnings	9	168.3p	155.9p
Dividends	7	60.6p	52.5p

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Balance sheets
at 31 December 2005

		Group		Company	
	Note	2005 £m	2004 £m	2005 £m	2004 £m
Assets					
Cash and balances at central banks		4,759	4,293	–	–
Treasury bills and other eligible bills	10	5,538	6,110	–	–
Loans and advances to banks	11	70,587	61,073	9,122	4,106
Loans and advances to customers	12	417,226	347,251	567	305
Debt securities	13	120,965	93,908	–	–
Equity shares	14	9,301	4,723	–	–
Investments in Group undertakings	15	–	–	20,851	21,900
Intangible assets	17	19,932	19,242	–	–
Property, plant and equipment	18	18,053	16,428	–	–
Settlement balances		6,005	5,682	–	–
Derivatives at fair value	19	95,663	17,800	55	–
Prepayments, accrued income and other assets	20	8,798	11,612	147	318
Total assets		776,827	588,122	30,742	26,629
Liabilities					
Deposits by banks	21	110,407	99,883	951	174
Customer accounts	22	342,867	283,315	55	–
Debt securities in issue	23	90,420	63,999	2,942	1,608
Settlement balances and short positions	24	43,988	32,990	–	–
Derivatives at fair value	19	96,438	18,876	–	–
Accruals, deferred income and other liabilities	25	14,247	17,648	14	301
Retirement benefit liabilities	3	3,735	2,940	–	–
Deferred taxation liabilities	26	1,695	2,061	–	–
Insurance liabilities	27	7,212	8,647	–	–
Subordinated liabilities	28	28,274	20,366	9,242	5,935
Total liabilities		739,283	550,725	13,204	8,018
Equity *					
Minority interests	29	2,109	3,492	–	–
Shareholders’ equity					
Called up share capital	30	826	822	826	822
Reserves	31	34,609	33,083	16,712	17,789
Total equity		37,544	37,397	17,538	18,611

Total liabilities and equity	776,827	588,122	30,742	26,629

* includes non-equity minority interests and preference shares in 2004.

The accounts were approved by the Board of directors on 27 February 2006 and signed on its behalf by:

Sir George Mathewson	Sir Fred Goodwin	Guy Whittaker
Chairman	*Group Chief Executive*	*Group Finance Director*

Statements of recognised income and expense

for the year ended 31 December 2005

	Note	Group 2005 £m	Group 2004 £m	Compan 2005 £m	
Available-for-sale investments					
Net valuation gains taken direct to equity		35		—	
Net profit taken to income on sales		(582)		—	
Cash flow hedges					
Net (losses)/gains taken direct to equity		(67)		6	
Exchange differences on translation of foreign operations		842	(606)	—	
Actuarial losses on defined benefit plans		(799)	(1,601)	—	
Other movements		—	—	—	
(Expense)/income before tax on items recognised direct in equity		(571)	(2,207)	6	
Tax on items recognised direct in equity		478	465	(2)	
Net (expense)/income recognised direct in equity		(93)	(1,742)	4	
Profit for the year		5,558	5,289	2,074	
Total recognised income and expense for the year		5,465	3,547	2,078	
Attributable to:					
Equity holders of the parent		5,355	3,558	2,078	
Minority interests		110	(11)	—	
		5,465	3,547	2,078	
Effect of changes in accounting policies on the implementation of IFRS					
Equity holders of the parent		(1,843)	1,243	(16,759)	(
Minority interests		(2,878)	(321)	—	
		(4,721)	922	(16,759)	(

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Cash flow statements

for the year ended 31 December 2005

		Group		Company	
	Note	2005 £m	2004 £m	2005 £m	2004 £m
Operating activities					
Operating profit before tax		7,936	7,284	1,932	2,890
Adjustments for:					
Depreciation and amortisation		1,825	1,674	–	–
Interest on subordinated liabilities		1,271	681	583	318
Charge for defined benefit pension schemes		462	397	–	–
Cash contribution to defined benefit pension schemes		(452)	(1,146)	–	–
Other non-cash items		338	(767)	(16)	1
Net cash inflow from trading activities		11,380	8,123	2,499	3,209
Changes in operating assets and liabilities		(519)	(4,264)	2,050	(148)
Net cash flows from operating activities before tax		10,861	3,859	4,549	3,061
Income taxes (paid)/received		(1,911)	(1,366)	(18)	36
Net cash flows from operating activities	36	8,950	2,493	4,531	3,097
Investing activities					
Sale and maturity of securities		39,472	43,022	–	–
Purchase of securities		(39,196)	(41,790)	–	–
Investment in subsidiaries		–	–	(2,961)	(6,342)
Sale of property, plant and equipment		2,220	1,921	–	–
Purchase of property, plant and equipment		(4,812)	(4,583)	–	–
Net investment in business interests and intangible assets	37	(296)	(7,968)	–	–
Loans to subsidiaries		–	–	(337)	(350)
Repayments to subsidiaries		–	–	1,183	40
Net cash flows from investing activities		(2,612)	(9,398)	(2,115)	(6,652)
Financing activities					
Issue of ordinary shares		163	2,845	163	2,845
Issue of equity preference shares		1,649	1,358	1,649	1,358
Issue of subordinated liabilities		1,234	4,624	337	1,424

Proceeds of minority interests acquired	1,264	1,260	—	—
Costs of minority interests redeemed	(121)	(2)	—	—
Repayments of subordinated liabilities	(1,553)	(718)	(1,183)	(40)
Dividends paid	(2,007)	(1,635)	(1,912)	(1,488)
Interest on subordinated liabilities	(1,332)	(613)	(577)	(318)
Net cash flows from financing activities	(703)	7,119	(1,523)	3,781
Effects of exchange rate changes on cash and cash equivalents	(3,107)	1,686	(76)	—
Net increase in cash and cash equivalents	2,528	1,900	817	226
Cash and cash equivalents 1 January	50,021	48,121	309	83
Cash and cash equivalents 31 December	52,549	50,021	1,126	309

Notes on the accounts

Introduction

IAS 32 Financial Instruments: Disclosure and Presentation, IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts were implemented by the Group on 1 January 2005 and applied prospectively from that date and, as permitted by IFRS, without restating comparatives. Consequently, in the notes on the accounts affected by these standards, comparative data for 2004 in accordance with previous GAAP have been presented.

1 Income from trading activities

	Group	
	2005 £m	2004 £m
Foreign exchange(1)	683	616
Securities		
equities(2)	39	36
debt(3)	1,023	811
Interest rate derivatives(4)	598	525
	2,343	1,988

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 Operating expenses

	Group	
	2005 £m	2004 £m
Administrative expenses		
Staff costs		
Wages, salaries and other staff costs	5,084	4,421
Social security costs	354	295
Share-based compensation	44	36
Pension costs (see note 3)		
defined benefit schemes	462	397
defined contribution schemes	48	39
	5,992	5,188
Premises and equipment	1,313	1,177

Other	2,816	2,323
	10,121	8,688
Depreciation and amortisation		
Property plant and equipment (see note 18)	1,326	1,155
Intangible assets (see note 17)	499	519
	11,946	10,362

The average number of persons employed by the Group during the year, excluding temporary staff, was 144,900 (2004 133,300).

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Notes on the accounts continued

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 Royal Bank of Scotland Group Pension Fund (□Main Scheme□), 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 income statement over the average remaining future service lives of the eligible employees. The amounts are not material.

Interim valuations of the Group□s schemes were prepared to 31 December by independent actuaries, using the following assumptions:

	Main Scheme		All Schemes	
Principal actuarial assumptions at 31 December (weighted average)	2005	2004	2005	2004
Discount rate	4.8%	5.4%	4.8%	5.4%
Expected return on plan assets	6.5%	6.7%	6.5%	6.8%
Rate of increase in salaries	4.0%	4.0%	3.9%	3.9%
Rate of increase in pensions in payment	2.7%	2.7%	2.6%	2.7%
Inflation assumption	2.7%	2.7%	2.7%	2.7%

The expected return on plan assets at 31 December is based upon the weighted average of the following assumptions of the returns on the major classes of plan assets:

	Main Scheme		All Schemes	
	2005	2004	2005	2004
Equities	7.7%	8.1%	7.7%	8.1%
Index-linked bonds	4.1%	4.5%	4.1%	4.5%
Government fixed interest bonds	4.1%	4.5%	4.1%	4.5%
Corporate and other bonds	4.8%	5.4%	4.8%	5.4%
Property	5.9%	6.3%	5.9%	6.3%
Cash and other assets	4.2%	4.6%	3.7%	4.5%

The expected return on Main Scheme plan assets at 31 December 2004 has been adjusted to reflect the investment, in early January 2005, of payments made to the fund on 31 December and included as cash and other assets at that date.

Post-retirement mortality assumptions (Main Scheme)	2005	2004	2003
Longevity at age 60 for current pensioners (years)			
Males	25.4	25.4	23.5
Females	28.2	28.2	25.3
Longevity at age 60 for future pensioners (years)			

Males	26.2	26.2	24.8
Females	29.0	29.0	26.5

	Main Scheme			All Schemes		
Changes in value of net pension liability	Fair value of plan assets £m	Present value of defined benefit obligations £m	Net pension liability £m	Fair value of plan assets £m	Present value of defined benefit obligations £m	Net pension liability £m
At 1 January 2004	11,797	13,594	1,797	12,862	14,898	2,036
Currency translation and other adjustments	—	—	—	(18)	(9)	9
Income statement:						
Expected return	838		(838)	920		(920)
Interest cost		759	759		837	837
Current service cost		400	400		469	469
Past service cost		—	—		11	11
	838	1,159	321	920	1,317	397
Statement of recognised income and expense:						
Actuarial gains and losses	392	1,825	1,433	408	2,009	1,601
Acquisitions of subsidiaries	—	—	—	45	88	43
Contributions by employer	1,069		(1,069)	1,146		(1,146)
Contributions by plan participants	—	—		3	3	
Benefits paid	(494)	(494)		(534)	(534)	
Expenses included in service cost	(33)	(33)		(34)	(34)	
At 31 December 2004	13,569	16,051	2,482	14,798	17,738	2,940
Currency translation and other adjustments	—	—	—	26	26	—
Income statement:						
Expected return	930		(930)	1,017		(1,017)
Interest cost		865	865		953	953
Current service cost		447	447		522	522
Past service cost		3	3		4	4
	930	1,315	385	1,017	1,479	462
Statement of recognised income and expense:						
Actuarial gains and losses	1,556	2,273	717	1,660	2,459	799
Disposal of subsidiaries	—	—	—	—	(14)	(14)
Contributions by employer	380		(380)	452		(452)
Contributions by plan participants	—	—		4	4	
Benefits paid	(504)	(504)		(550)	(550)	
Expenses included in service cost	(17)	(17)		(19)	(19)	
At 31 December 2005	15,914	19,118	3,204	17,388	21,123	3,735

The Group expects to contribute £444 million to its defined benefit pension schemes in 2006 (Main Scheme £384 million). Of the net pension liability, £104 million (2004 £95 million) relates to unfunded schemes.

Notes on the accounts continued

3 Pension costs *(continued)*

Major plan assets as a percentage of total plan assets	Main Scheme		All Schemes	
	2005	2004	2005	2004
Equities	61.3%	56.7%	61.6%	57.2%
Index-linked bonds	18.1%	16.5%	16.8%	15.3%
Government fixed interest bonds	1.8%	2.1%	2.6%	2.8%
Corporate and other bonds	14.6%	12.5%	14.6%	12.7%
Property	3.6%	3.1%	3.7%	3.2%
Cash and other assets	0.6%	9.1%	0.7%	8.8%

The pension plan assets include a holding of the company's ordinary shares with a fair value of £78 million (2004 – £73 million), of which £76 million (2004 – £71 million) are held in the Main Scheme which also holds financial instruments issued by the Group with a value of £299 million (2004 – £726 million).

Cumulative net actuarial losses of £2,400 million (2004 – £1,601 million) have been recognised in the statement of recognised income and expense, of which £2,150 million (2004 – £1,433 million) relate to the Main Scheme.

History of defined benefit schemes	Main Scheme			All Schemes		
	2005 £m	2004 £m	2003 £m	2005 £m	2004 £m	2003 £m
Present value of defined benefit obligations	19,118	16,051	13,594	21,123	17,738	14,898
Fair value of plan assets	15,914	13,569	11,797	17,388	14,798	12,862
Net deficit	3,204	2,482	1,797	3,735	2,940	2,036
Experience losses on plan liabilities	(41)	(624)		(68)	(631)	
Experience gains on plan assets	1,556	392		1,660	408	
Actual return on pension schemes assets	2,486	1,230		2,677	1,328	

4 Operating profit before tax

Operating profit before tax is stated after taking account of the following:

		Group	
		2005 £m	2004 £m
Income	Sales of available-for-sale securities		
	– Gross gains	683	
	– Gross losses	(16)	
	– Net profit	667	

	Sales of investment securities		
	Gross gains		197
	Gross losses		(30)
	Net profit		167
	Dividend income	108	79
	Share of associated undertakings net profit	41	24
	Rental income from investment properties	250	241
	Net gains on financial assets and liabilities designated as at fair value through profit or loss	364	
Expenses	Interest on subordinated liabilities	1,271	681
	Direct operating expenses of investment properties	61	72
	Integration expenditure* relating to:		
	acquisition of NatWest	129	280
	other acquisitions	329	240

* Integration expenditure comprises:			
	Staff costs	148	83
	Premises and equipment	39	35
	Other administrative expenses	131	149
	Depreciation and amortisation	140	253
		458	520

Auditors remuneration

Amounts paid to the auditors for statutory audit and other services were as follows:

	Group	
	2005 £m	2004 £m
Audit services		
Statutory audit	9.9	8.2
Audit related including regulatory reporting*	7.0	1.1
	16.9	9.3
Further assurance services	6.8	3.0
Tax services		
Compliance services	0.2	0.2
Advisory services		0.2
	0.2	0.4
Other services	0.4	3.0
Total	24.3	15.7

* Includes fees relating to the transition to IFRS and work in respect of US Sarbanes-Oxley Act Section 404 reporting requirements.

The auditors remuneration for statutory audit of the company was £0.1 million (2004 £0.1 million). Nonaudit fees paid to the auditors and their associates in the UK was £12.4 million (2004 £6.4 million).

5 Tax

	Group	
	2005 £m	2004 £m
Current taxation:		
UK corporation tax charge for the year at 30%	2,280	2,091
Over provision in respect of prior periods	(101)	(168)
Relief for overseas taxation	(171)	(212)
	2,008	1,711
Deferred taxation:		
Current year charge	477	333
Over provision in respect of prior periods	(107)	(49)
Tax charge for the year	2,378	1,995

The actual tax charge differs from the expected tax charge computed by applying the standard rate of UK corporation tax of 30% as follows:

	2005 £m	2004 £m
Expected tax charge	2,381	2,185
Interest on subordinated debt not allowable for tax	79	
Non-deductible items	230	110
Non-taxable items	(166)	(128)
Taxable foreign exchange movements	(10)	(10)
Foreign profits taxed at other rates	77	49
Unutilised losses brought forward and carried forward	(5)	6
Adjustments relating to prior periods	(208)	(217)
Actual tax charge for the year	2,378	1,995

(1) Deferred tax assets of £51 million (2004 £110 million) resulting from tax losses carried forward of £150 million (2004 £291 million) have not been recognised as it is currently not certain that the assets 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.

Notes on the accounts continued

6 Profit attributable to preference shareholders

	Group		
	Dividends paid to equity preference shareholders 2005 £m	Finance cost included in interest payable 2005 £m	Finance cost of preference shares 2004 £m
Non-cumulative preference shares of US$0.01	58	115	105
Non-cumulative convertible preference shares of US$ 0.01		73	90
Non-cumulative convertible preference shares of 0.01		9	33
Non-cumulative preference shares of 0.01	51		4
Non-cumulative convertible preference shares of £0.01		15	15
Appropriation for premium payable on redemption and issue costs		8	9
Total[3]	109	220	256
Equity			15
Non-equity			241

Notes:

(1) In the year ended 31 December 2005, dividends of £55,000 (2004 £55,000) were paid on the 11% cumulative preference shares of £1 and dividends of £22,000 (2004 £22,000) were paid on the 5.5% cumulative preference shares of £1.

(2) Following the implementation of IAS 32 on 1 January 2005, several of the Groups preference share issues are now included in subordinated liabilities and the finance cost thereon is included in interest payable.

(3) Between 1 January 2006 and the date of approval of these accounts, dividends amounting to US$39 million have been declared in respect of equity preference shareholders for payment on 31 March 2006.

7 Ordinary dividends

	Group			
	2005 p per share	2004 p per share	2005 £m	2004 £m
Final dividend for previous year declared during the current year	41.2	35.7	1,308	1,059
Interim dividend	19.4	16.8	619	529
Total dividends paid on ordinary equity shares	60.6	52.5	1,927	1,588

Final dividends are not accounted for until they have been ratified at the Annual General Meeting. At the meeting on 28 April 2006, a dividend in respect of 2005 of 53.1 pence per share (2004 41.2 pence per share) amounting to a total of £1.7 billion (2004 £1.3 billion) is to be proposed. The financial statements for the year ended 31 December 2005 do not reflect this dividend which, if approved, will be accounted for in shareholders equity as an appropriation of retained profits in the year ending 31 December 2006.

8 Profit dealt with in the accounts of the company

As permitted by section 230(3) of the Companies Act 1985, the primary financial statements of the company do not include an income statement. Condensed information is set out below:

	Company	
	2005 £m	2004 £m
Dividends received from banking subsidiary	2,082	3,000
Dividends received from other subsidiaries	100	—
Total income	2,182	3,000
Interest receivable from subsidiaries	577	313
Interest payable to subsidiaries	(189)	(150)
Other net interest payable and operating expenses	(638)	(273)
Operating profit before tax	1,932	2,890
Tax	142	(16)
Profit for the year	2,074	2,874
Profit attributable to:		
Ordinary shareholders	1,965	2,618
Other shareholders	109	256
	2,074	2,874

9 Earnings per ordinary share

The earnings per share are based on the following:

	Group	
	2005 £m	2004 £m
Earnings:		
Profit attributable to ordinary shareholders	5,392	4,856
Add back dividends on dilutive convertible non-equity shares	65	66
Diluted earnings attributable to ordinary shareholders	5,457	4,922
	Number of shares millions	
Number of ordinary shares:		
Weighted average number of ordinary shares in issue during the year	3,183	3,085
Effect of dilutive share options and convertible non-equity shares	60	73
Diluted weighted average number of ordinary shares during the year	3,243	3,158

All convertible preference shares have a dilutive effect in the current year and as such have been included in the computation of diluted earnings per share. In 2004, $1,500 million of convertible preference shares was not included in the computation of diluted earnings per share as their effect was anti-dilutive.

10 Treasury bills and other eligible bills

	Group	
	2005 £m	2004 £m
Treasury bills and similar securities	5,402	5,538
Other eligible bills	136	572
	5,538	6,110
Held-for-trading	3,004	
Available-for-sale	2,534	
	5,538	

11 Loans and advances to banks

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Held-for-trading	44,965			
Designated as at fair value through profit or loss	282			
Loans and receivables	25,340		9,122	

	70,587	61,073	9,122	4,106
Amounts above include:				
Items in the course of collection from other banks	2,901	2,629		
Due from subsidiaries			9,122	4,106

12 Loans and advances to customers

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Held-for-trading	53,963		—	
Designated as at fair value through profit or loss	616		—	
Loans and receivables	350,960		567	
Finance leases	11,687		—	
	417,226	347,251	567	305
Amounts above include:				
Due from subsidiaries			567	305
Subordinated advances		220		—

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Notes on the accounts continued

12 Loans and advances to customers *(continued)*

Securitisations

The Group engages in securitisation transactions of its financial assets including commercial and residential mortgage loans, commercial and residential mortgage related securities, US Government agency collateralised mortgage obligations, and other types of financial assets. In such transactions, the assets, or interests in the assets, are transferred generally to a special purpose entity which then issues liabilities to third party investors.

Securitisations may, depending on the individual arrangement, result in continued recognition of the securitised assets; continued recognition of the assets to the extent of the Group's continuing involvement in those assets; or derecognition of the assets and the separate recognition, as assets or liabilities, of any rights and obligations created or retained in the transfer (see Accounting policies on page 93). The Group has securitisations in each of these categories.

Continued recognition

The table below sets out the asset categories together the carrying amounts of the assets and associated liabilities.

	2005		2004	
Asset type	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Residential mortgages (1, 2)	2,388	2,366	1,519	1,479
Finance lease receivables (1, 3)	1,467	1,170	1,897	1,502
Other loans (1, 4)	2,189	1,543	1,713	1,313
Credit card receivables (5)	2,891	2,836	1,133	1,133
Commercial paper conduits (6)	6,688	6,685	4,704	4,696

(1) At 31 December 2004, in accordance with previous GAAP, the financial assets in these categories were derecognised to the extent of non-recourse finance as the arrangements qualified for the linked presentation.

(2) Mortgages have been transferred to special purpose vehicles, held ultimately by charitable trusts, funded principally through the issue of floating rate notes. 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. In 2004, the Group recognised net income of £26 million.

(3) Certain finance lease receivables (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. In 2004, the Group recognised net income of £13 million.

(4) Other loans originated by the Group have been transferred to special purpose vehicles funded through the issue of notes. 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. In 2004, the Group recognised net income of £37 million.

(5) Credit card receivables in the UK have been securitised. Notes have been issued by a special purpose vehicle. The note holders have a proportionate interest in a pool of credit card receivables that have been equitably assigned by the Group to a receivables trust. The Group continues to be exposed to the risks and rewards of the transferred receivables through its right to excess spread (after charge offs).

(6) The Group sponsors commercial paper conduits. Customer assets are transferred into an SPE which issues notes in the commercial paper market. The Group supplies certain services and contingent liquidity support to these

vehicles on an arm's length basis as well as programme credit enhancement.

Continuing involvement

In certain US securitisations of residential mortgages substantially all the risks and rewards have been neither transferred nor retained, but the Group has retained control, of the assets and continues to recognise the assets to the extent of its continuing involvement. Securitised assets were £39.8 billion; retained interests £863 million; subordination assets £609 million and related liabilities £609 million.

Derecognition

Other securitisations of the Groups financial assets in the US qualify for derecognition as substantially all the risks and rewards of the assets been transferred The Group continues to recognise any retained interests in the securitisation vehicles.

Disclosures are given below about those securitisations of financial assets undertaken by the Group that resulted in derecognition or recognition to the extent of continuing involvement. The Group has classified these securitisations into three broad categories: US Agency, consumer, and commercial securitisations. During 2005, the Group received proceeds of approximately £46.3 billion from securitisation trusts in connection with new securitisations of Group assets and £9.6 billion in connection with securitisation of third-party assets.

The Group recognised net pre-tax gains of approximately £182 million (2004 £111 million) relating to these securitisations. Net pre-tax gains are based on the difference between the sales prices and previous carrying values of assets prior to date of sale, are net of transaction costs, and exclude any results attributable to hedging activities, interest income, funding costs, and changes in asset values prior to, and in retained interest values subsequent to, the securitisation date.

At 31 December 2005, the fair value of the Groups retained interests was approximately £2.1 billion (2004 £1.4 billion). These retained interests comprise approximately £1,179 million in US Agency based retained interests, £764 million in consumer based retained interests and £128 million in commercial based retained interests. These retained interests primarily relate to mortgage loans and securities and arose from securitisations that have taken place in current and prior years. Cash flows received in 2005 from retained interests held at 31 December 2005 in connection with securitisations that took place in current and prior years amounted to approximately £481 million (2004 £383 million).

Notes on the accounts continued

12 Loans and advances to customers *(continued)*

Key economic assumptions used in measuring the value of retained interests at the date of securitisation resulting from securitisations completed during the year were as follows:

Assumptions	U.S. Agency retained interests	Consumer retained interests	Commercial retained interests
Prepayment speed	139 – 690PSA	16 – 44% CPR(1)	0 – 100 CPY(1)
Weighted average life	1 – 20 years	1 – 10 years	1 – 20 years
Cash flow discount rate	0– 26%	4– 90%	5– 81%
Credit losses	N/A(3)	0 – 2% CDR(4)	N/A(5)

Key economic assumptions and the sensitivity of the current fair value of retained interests at 31 December 2005 to immediate adverse changes, as indicated below, in those assumptions are as follows:

Assumptions/impact on fair value	U.S. Agency retained interests	Consumer retained interests	Commercial retained interests
Fair value of retained interests at 31 December 2004	£1,179 million	£764 million	£128 million
Prepayment speed(6)	9 – 25% CPR(1)	16 – 80% CPR(1)	0 – 75 CPY(2)
Impact on fair value of 10% adverse change	£0.5 million	£26.1 million	–
Impact on fair value of 20% adverse change	£0.6 million	£47.1 million	–
Weighted average life	0 – 19 years	1 – 10 years	1 – 20 years
Cash flow discount rate	0– 26%	4– 96%	5– 81%
Impact on fair value of 10% adverse change	£33.5 million	£23.8 million	£4.7 million
Impact on fair value of 20% adverse change	£65.1 million	£46.0 million	£9.1 million
Credit losses	N/A(3)	0 – 2% CDR(4)	N/A(5)
Impact on fair value of 10% adverse change	N/A	£10.9 million	N/A
Impact on fair value of 20% adverse change	N/A	£19.8 million	N/A

Notes:

(1) Constant prepayment rate – the CPR range represents the low and high points of a dynamic CPR curve.

(2) CPR with yield maintenance provision and thus prepayment risk is limited.

(3) Population consists of securities whose collateral is guaranteed by US Government sponsored entities and therefore, no credit loss has been assumed.

(4) Constant default rate.

(5) Population consists of only investment grade senior tranches; therefore, no credit losses are included in the assumptions.

(6) Prepayment speed has been stressed on an overall portfolio basis for US Agency retained interests due to the overall homogeneous nature of the collateral. Consumer and commercial retained interests have been stressed on a security level basis.

The sensitivities depicted in the preceding table are hypothetical and should be used with caution. The likelihood of those percent variations selected for sensitivity testing is not necessarily indicative of expected market movements because the relationship of the change in the assumptions to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of a retained interest is calculated without changing any other assumptions. This might not be the case in actual market conditions since changes in one factor might result in changes to other factors. Further, the sensitivities depicted above do not consider any corrective actions that the Group might take to mitigate the effect of any adverse changes in one or more key assumptions.

Mortgage-backed securities

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. At 31 December 2005 mortgages amounting to £385 million (2004 - £472 million) had been sold with recourse and the related securities sold. These loans have been derecognised; they qualified for the linked presentation under previous GAAP.

13 Debt securities

2005	UK government £m	Other government £m	Other public sector body £m	Bank and building society £m	Other issuers £m	Total £m
	Group					
Held-for-trading	4,386	18,073	257	8	57,929	80,653
Designated as at fair value through profit or loss	451	7	–	864	2,669	3,991
Available-for-sale	662	17,807	40	9,613	7,411	35,533
Loans and receivables	–	–	–	–	788	788
At 31 December 2005	5,499	35,887	297	10,485	68,797	120,965
Available-for-sale						
Gross unrealised gains	9	9	–	7	41	66
Gross unrealised losses	(7)	(277)	(1)	(6)	(64)	(355)
2004						
Investment securities	757	14,135	309	9,355	10,987	35,543
Other securities	1,866	12,457	37	1,701	42,304	58,365
At 31 December 2004(1)	2,623	26,592	346	11,056	53,291	93,908
Investment securities:						
Book value	757	14,135	309	9,355	10,987	35,543
Gross unrecognised gains	2	85	1	5	78	171
Gross unrecognised losses	(22)	(44)	–	(4)	(285)	(355)
Valuation at 31 December 2004	737	14,176	310	9,356	10,780	35,359

(1) Amounts above include subordinated debt securities of £644 million at 31 December 2004.

2005	Listed £m	Unlisted £m	Total £m
Held-for-trading	41,544	39,109	80,653
Designated as at fair value through profit or loss	3,043	948	3,991

Available-for-sale	34,074	1,459	35,533
Loans and receivables		788	788
At 31 December 2005	78,661	42,304	120,965
2004			
Investment securities	25,647	9,896	35,543
Other securities	30,946	27,419	58,365
At 31 December 2004	56,593	37,315	93,908

The following table shows the Groups available-for-sale debt securities by remaining maturity and the related yield (based on weighted averages) as at 31 December 2005.

	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	111	7.0	357	5.6	187	5.5	7	2.3	662	5.8
US government, federal agencies and states	52	2.2	292	2.3	829	1.9	14,976	3.6	16,149	3.5
Other government	604	1.9	1,088	4.1	4	5.0	3	4.5	1,699	3.3
Corporate debt securities	640	3.8	1,492	3.9	222	4.7	191	5.1	2,545	4.0
Mortgage-backed securities	27	4.7	13	6.0	511	5.8	3,230	3.6	3,781	3.9
Bank and building society	7,853	4.3	1,567	3.9	156	4.1	37	4.5	9,613	4.3
Other	837	3.1	56	2.8	3	6.8	188	4.8	1,084	3.4
Total fair value	10,124	4.1	4,865	4.0	1,912	3.8	18,632	3.6	35,533	3.8

Notes on the accounts continued

13 Debt securities *(continued)*

The table below shows the number and fair value of available-for-sale debt-securities that were in an unrealised loss position at 31 December 2005.

	Less than 12 months			More than 12 months		Total	
Issued by	Number of issues	Fair value £m	Gross unrealised losses £m	Fair value £m	Gross unrealised losses £m	Fair value £m	Gross unrealised losses £m
UK government	9	–	–	217	7	217	7
US government, federal agencies and states	511	13,390	228	1,475	35	14,865	263
Other government	54	1,136	7	149	7	1,285	14
Corporates	21	157	3	54	1	211	4
Mortgage-backed securities	110	2,797	55	149	4	2,946	59
Bank and building society	159	5,417	4	156	2	5,573	6
Other	5	–	2	6	–	6	2
	869	22,897	299	2,206	56	25,103	355

The Group considers that unrealised losses on available-for-sale debt securities are temporary principally because they reflect changes in benchmark interest rates.

14 Equity shares

	Group					
	Listed £m	Unlisted £m	2005 Total £m	Listed £m	Unlisted £m	2004 Total £m
Held-for-trading	2,937	4	2,941			
Designated as at fair value through profit or loss	2,113	428	2,541			
Available-for-sale	704	3,115	3,819			
	5,754	3,547	9,301			
Investment securities				1,213	1,227	2,440
Other securities				2,282	1	2,283
At 31 December				3,495	1,228	4,723
Available-for-sale						
Gross unrealised gains	168	54	222			
Gross unrealised losses	(5)	(8)	(13)			

	163	46	209

Investment securities			
Book value	1,213	1,227	2,440
Gross unrecognised gains	356	169	525
Gross unrecognised losses	(78)	(5)	(83)
	1,491	1,391	2,882

Unquoted equity investments at cost include £1.8 billion attributable to the Groups investment in Bank of China which was completed on 31 December 2005. Also included are equity investments in the Federal Home Loans Bank and Federal Reserve Bank that are redeemable at cost (£0.8 billion). The remaining investments at cost cannot be measured reliably and comprised numerous small shareholdings including those received on trouble debt restructuring. Disposals in the year generated gains of £85 million.

At 31 December 2005 the £13 million gross unrealised losses represented 23 equity issues with fair value of £30 million which were in an unrealised loss position for less than 12 months.

15 Investments in Group undertakings

Investments in Group undertakings are carried at cost less impairment. Movements during the year were as follows:

	Company	
	2005 £m	2004 £m
At 1 January	21,900	15,497
Implementation of IAS 32 and IAS 39 on 1 January 2005	(4,004)	
Currency translation and other adjustments	(6)	(399)
Additions	2,961	6,802
At 31 December	20,851	21,900

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 wholly owned directly, or indirectly through intermediate holding companies, by these companies. 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.

Notes on the accounts continued

16 Impaired and past-due financial assets

2005	Group Cost £m	Provision £m	Net book value £m
Impaired financial assets			
Loans and receivables and finance leases	5,926	3,344	2,582
Available-for-sale	316	132	184
	6,242	3,476	2,766

	Group 2005 £m	2004 £m
Impairment losses charged to the income statement		
Loans and receivables and finance leases (see table below)	1,703	
Available-for-sale	4	
Loans and advances (see table below)		1,402
Amounts written-off fixed asset investments		83
Total	1,707	1,485

The following table shows impairment losses for loans and receivables and finance leases (2004 loans and advances).

	Group 2005 £m	Specific £m	General £m	2004 Total £m
At 1 January	4,174	3,332	553	3,885
Implementation of IAS 39	(29)			
Currency translation and other adjustments	51	(22)	(76)	(98)
Acquisitions		222	68	290
Amounts written-off [(1)]	(2,040)	(1,449)		(1,449)
Recoveries of amounts previously written-off	172	144		144
Charged to the income statement	1,703	1,386	16	1,402
Unwind of discount	(144)			
At 31 December [(2)]	3,887	3,613	561	4,174

(1) Amounts written-off during the year include £2 million relating to banks (2004 – nil).

(2) Balance at 31 December 2005 includes £3 million relating to banks (2004 – £6 million).

Loan impairment

At 31 December 2005, the Group's non-accrual loans, loans past due 90 days and troubled debt restructurings amounted to £5,937 million (2004 – £5,470 million). Loan impairment provisions of £3,344 million (2004 – £3,561 million) were held against these loans. Average non-accrual loans, loans past due 90 days and troubled debt restructurings for the year to 31 December 2005 were £5,923 million (2004 – £5,264 million).

	IFRS	
	2005 £m	2004 £m
Gross income not recognised but which would have been recognised under the original terms of non-accrual and restructured loans		
Domestic	334	235
Foreign	62	58
	396	293
Interest on non-accrual and restructured loans included in net interest income		
Domestic	130	58
Foreign	14	7
	144	65

17 Intangible assets

	Group				
2005	Goodwill £m	Core deposit intangibles £m	Other purchased intangibles £m	Internally generated software £m	Total £m
Cost:					
At 1 January 2005	18,032	268	261	2,089	20,650
Currency translation and other adjustments	786	31	30	—	847
Acquisition of subsidiaries	113	—	—	—	113
Additions	—	—	34	329	363
Disposals and write-off of fully amortised assets	(108)	—	—	(124)	(232)
At 31 December 2005	18,823	299	325	2,294	21,741
Accumulated amortisation and impairment:					
At 1 January 2005	—	22	22	1,364	1,408
Currency translation and other adjustments	—	5	3	—	8
Disposals and write-off of fully amortised assets	—	—	—	(106)	(106)
Charge for the year	—	58	39	402	499
At 31 December 2005	—	85	64	1,660	1,809
Net book value at 31 December 2005	18,823	214	261	634	19,932
2004					
Cost:					
At 1 January 2004	13,131	—	—	1,827	14,958
Currency translation and other adjustments	(518)	(18)	(2)	—	(538)
Acquisition of subsidiaries	5,435	286	263	—	5,984
Additions	—	—	—	303	303
Disposals and write-off of fully amortised assets	(16)	—	—	(41)	(57)
At 31 December 2004	18,032	268	261	2,089	20,650
Accumulated amortisation and impairment:					
At 1 January 2004	—	—	—	931	931
Currency translation and other adjustments	—	(1)	—	—	(1)

Disposals and write-off of fully amortised assets				(41)	(41)
Charge for the year		23	22	474	519
At 31 December 2004		22	22	1,364	1,408
Net book value at 31 December 2004	18,032	246	239	725	19,242

The weighted average amortisation period of purchased intangible assets, other than goodwill, subject to amortisation are:

	Years
Core deposit intangibles	6
Other purchased intangibles	7

The amortisation expense for each of the next five years is currently estimated to be:

	£m
2006	113
2007	113
2008	113
2009	67
2010	20

Notes on the accounts continued

17 Intangible assets *(continued)*

Impairment review

Significant Business Division	Acquisition	Cash generating unit	Goodwill 2005 [(1)] £m	Goodwill 2004 £m	Basis of valuation	Key assumptions
Corporate Markets	NatWest*	Core corporate banking	1,888	1,888[(2)]	Earnings	Allocation of common resources
Corporate Markets	NatWest*	Financial markets	1,563	1,563[(2)]	Earnings	
Retail Banking	NatWest*	NatWest Retail	3,095	2,721[(2)]	Earnings	
Citizens	Mellon	Mid-Atlantic	1,209	1,197[(1)]	Expected earnings and cash generation multiples, including control premium	Mellon business typical of recent transactions in the same region
Citizens (acquired 2004)	Charter One	Charter One	4,471		Value-in-use: cash flow	Terminal growth rate after year 7**
RBS Insurance	Churchill	Churchill Group	794	775[(1)]	Value-in-use: cash flow	Terminal growth rate after year 7**

(1) As at 30 September.

(2) As at 1 January 2004.

* Of the overall goodwill arising from the acquisition of NatWest in 2000, £2.7 billion (2004 £3.1 billion) has been allocated to cash generating units other than those shown above.

** The key valuation parameters are the same as those used to support the Groups decision to purchase the businesses.

18 Property, plant and equipment

2005	Group Investment properties £m	Freehold premises £m	Long leasehold premises £m	Short leasehold premises £m	Computers and other equipment £m	Operatin[g] leas[e] asse[ts] £[m]
Cost or valuation:						
At 1 January 2005	4,162	2,878	404	842	3,143	9,44

Currency translation and other adjustments	(55)	17	11	18	67	46
Reclassifications	(2)	34	(31)	—	(1)	
Additions	348	331	25	322	597	3,13
Subsequent expenditure on investment properties	53	—	—	—	—	
Change in fair value of investment properties	26	—	—	—	—	
Disposals and write-off of fully depreciated assets	(176)	(560)	(71)	(127)	(466)	(1,37
Disposals of subsidiaries	(9)	(19)	—	(10)	(30)	(11
At 31 December 2005	4,347	2,681	338	1,045	3,310	11,56
Accumulated depreciation and amortisation:						
At 1 January 2005	—	417	138	280	1,831	1,78
Currency translation and other adjustments	—	4	—	6	31	14
Disposals and write-off of fully depreciated assets	—	(91)	(24)	(29)	(340)	(15
Disposals of subsidiaries	—	—	—	(2)	(21)	(5
Depreciation charge for the year	—	60	7	64	390	80
At 31 December 2005	—	390	121	319	1,891	2,51
Net book value at 31 December 2005	4,347	2,291	217	726	1,419	9,05

	Group						
2004	Investment properties £m	Freehold premises £m	Long leasehold premises £m	Short leasehold premises £m	Computers and other equipment £m	Operating lease assets £m	Total £m
Cost:							
At 1 January 2004	4,076	2,635	312	655	2,712	7,537	17,927
Currency translation and other adjustments	2	(18)	—	(10)	(42)	(184)	(252)
Reclassifications	—	1	(5)	(5)	9	—	—
Acquisition of subsidiaries	—	164	32	41	133	487	857
Additions	164	589	86	212	691	2,841	4,583
Disposals and write-off of fully depreciated assets	(80)	(493)	(21)	(51)	(360)	(1,234)	(2,239)
At 31 December 2004	4,162	2,878	404	842	3,143	9,447	20,876
Accumulated depreciation and amortisation:							
At 1 January 2004	—	407	129	280	1,537	1,327	3,680
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)	(130)	(232)	(387)
Depreciation charge for the year	—	30	3	9	425	688	1,155
At 31 December 2004	—	417	138	280	1,831	1,782	4,448
Net book value at 31 December 2004	4,162	2,461	266	562	1,312	7,665	16,428

	2005 £m	2004 £m
Contracts for future capital expenditure not provided for in the accounts at the year end (excluding investment properties)	38	447
Contractual obligations to purchase, construct or develop investment properties or to repair, maintain or enhance investment property	4	155
Property, plant and equipment pledged as security	1,250	1,268

Investment properties are valued to reflect fair market value. Valuations are carried out by qualified surveyors who are members of the Royal Institution of Chartered Surveyors, or an equivalent overseas body. The 31 December 2005 valuation for a significant majority of the Group□s investment properties was undertaken by external valuers.

The fair value of investment properties includes £100 million (2004 □ £74 million) of appreciation since purchase. This increase would normally be realised on disposal of the properties. Premises include £84 million (2004 □ £570 million) assets in the course of construction.

Notes on the accounts continued

19 Derivatives at fair value

Companies in the Group enter into various off-balance sheet financial instruments (derivatives) as principal either as a trading activity or to manage balance sheet foreign exchange and interest rate risk. Derivatives include swaps, forwards, futures and options. They may be traded on an organised exchange (exchange-traded) or over-the-counter (OTC). Holders of exchange traded derivatives are generally required to provide margin daily in the form of cash or other collateral.

Swaps include currency swaps, interest rate swaps, credit default swaps, total return swaps and equity and equity index swaps. A swap is an agreement to exchange cash flows in the future in accordance with a pre-arranged formula. In currency swap transactions, interest payment obligations are exchanged on assets and liabilities denominated in different currencies; the exchange of principal may be notional or actual. Interest rate swap contracts generally involve exchange of fixed and floating interest payment obligations without the exchange of the underlying principal amounts.

Forwards include forward foreign exchange contracts and forward rate agreements. A forward contract is a contract to buy (or sell) a specified amount of a physical or financial commodity, at agreed price, on an agreed future date. Forward foreign exchange contracts are contracts for the delayed delivery of currency on a specified future date. Forward rate agreements are contracts under which two counterparties agree on the interest to be paid on a notional deposit of a specified maturity at a specific future date; there is no exchange of principal.

Futures are exchange-traded forward contracts to buy (or sell) standardised amounts of underlying physical or financial commodities. The Group buys and sells currency, interest rate and equity futures.

Options include exchange-traded options on currencies, interest rates and equities and equity indices and OTC currency and equity options, interest rate caps and floors and swaptions. They are contracts that give the holder the right but not the obligation to buy (or sell) a specified amount of the underlying physical or financial commodity at an agreed price on an agreed date or over an agreed period.

The Group enters into fair value and cash flow hedges and hedges of net investments in foreign operations. Fair value hedges principally involve interest rate swaps hedging the interest rate risk in recognised financial assets and financial liabilities. Similarly the majority of the Group's cash flow hedges relate to exposure to variability in future interest payments and receipts on forecast transactions and on recognised financial assets and financial liabilities and hedged by interest rate swaps for periods of up to 28 years. The Group hedges its net investments in foreign operations with currency borrowings.

	Group		
	Total derivatives		
2005	Notional amounts £bn	Assets £m	Liabilities £m
Exchange rate contracts			
Spot, forwards and futures	885	10,758	10,214
Currency swaps	221	3,228	3,849
Options purchased	301	6,438	—
Options written	315	—	6,101
Interest rate contracts			
Interest rate swaps	7,234	65,618	67,156

Options purchased	814	5,988	�
Options written	719	�	5.557
Futures and forwards	1,482	268	325
Credit derivatives	217	1,455	1,355
Equity and commodity contracts	61	1,910	1,881
		95,663	96,438
Included in the above are cash flow hedging derivatives as follows:			
Spot, forwards and futures		5	25
Interest rate swaps		431	373
Included in the above are fair value hedging derivatives as follows:			
Interest rate swaps		1,096	676

The company held derivative assets at fair value amounting to £55 million (notional amounts £1 billion).

	Group		
		Trading derivatives Fair value	
2004	Notional amounts £bn	Assets £m	Liabilities £m
Exchange rate contracts			
Spot, forwards and futures	746	17,133	18,566
Currency swaps	178	6,281	6,314
Options purchased	243	5,797	—
Options written	256	—	5,324
Interest rate contracts			
Interest rate swaps	4,939	54,964	55,360
Options purchased	296	3,168	—
Options written	287	—	3,274
Futures and forwards	1,091	475	479
Credit derivatives	59	264	285
Equity and commodity contracts	41	1,227	783
		89,309	90,385
Effect of netting		(71,509)	(71,509)
		17,800	18,876

Non-trading derivatives

Under previous GAAP, hedging derivatives were accounted for in accordance with the treatment of the hedged transaction. As a result any gains or losses on the hedging instrument arising from changes in fair values were not recognised in the profit and loss account immediately but accounted for in the same manner as the hedged item. The Group established such non-trading derivative positions externally with third parties and also internally. The tables below include the components of the internal hedging programme that transferred risks to the trading portfolio or to external third party participants in the derivatives market.

	Group				
		Fair value		Book value	
2004	Notional amounts £bn	Positive £m	Negative £m	Assets £m	Liabilities £m
Exchange rate contracts					
Spot, forwards and futures	21	46	665	35	603
Currency swaps and options	5	349	227	234	123

Interest rate contracts					
Interest rate swaps	121	1,617	1,342	623	650
Futures, forwards and options	14	71	318	2	2
Credit derivatives	1	4	11		6
Equity and commodity contracts	2	207	62	102	15
		2,294	2,625	996	1,399

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Notes on the accounts continued

19 Derivatives at fair value *(continued)*

2004	Group Unrecognised gains and losses £m	 Deferred gains and losses £m
As at 1 January 2004 gains	2,236	213
losses	(2,205)	(34)
	31	179
Recognised gains that arose in previous periods	(781)	(65)
Recognised losses that arose in previous periods	537	4
Unrecognised gains and losses arising in the year	224	
Unrecognised gains and losses deferred in the year	61	(61)
Unrecognised gains and losses deferred and taken to profit or loss in the year		(30)
At 31 December 2004	72	27
Of which gains	1,571	483
losses	(1,499)	(456)
	72	27

Maturity of replacement cost of over-the-counter contracts (trading and non-trading)

Replacement cost indicates the Groups derivatives credit exposure. The following table sets forth the gross positive fair values by maturity. The replacement cost of internal trades is not included as there is no credit risk associated with them.

2004	Group Within one year £m	 One to five years £m	 Over five years £m	 Total £m
Before netting				
Exchange rate contracts	21,812	5,414	2,018	29,244
Interest rate contracts	6,777	24,932	27,287	58,996
Credit derivatives		107	157	264
Equity and commodity contracts	604	777	13	1,394
	29,193	31,230	29,475	89,898
Financial institutions				70,417
Others				19,481

	89,898

20 Prepayments, accrued income and other assets

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Prepayments	1,274	1,505	—	—
Accrued income	857	4,541	—	208
Deferred expenses	372	898	—	—
Other assets	6,295	4,668	147	110
	8,798	11,612	147	318
Amounts above include:				
Due from subsidiaries			—	313

21 Deposits by banks

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Held-for-trading	32,067		—	
Amortised cost	78,340		951	
	110,407	99,883	951	174
Amounts above include:				
Items in the course of transmission to other banks	722	802		
Due to subsidiaries			944	108

22 Customer accounts

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Held-for-trading	34,645		—	
Designated as at fair value through profit or loss (1)	3,683		—	
Amortised cost	304,539		55	
	342,867	283,315	55	—
Amounts above include:				
Due to subsidiaries			55	—

(1) The amounts include insurance linked liabilities with a carrying value of £2,296 million. The carrying amount of other customer accounts designated as at fair value through profit or loss is £114 million greater than amortised cost. No amounts have been recognised in profit or loss for changes in credit risk associated with these liabilities as the changes are immaterial measured as the change in fair value from movements in the period in the credit risk premium payable by the Group.

23 Debt securities in issue

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Held-for-trading	1,469		—	
Designated as at fair value through profit or loss (1)	11,068		—	
Amortised cost	77,883		2,942	
	90,420	63,999	2,942	1,608

(1) No amounts have been recognised in profit or loss for changes in credit risk associated with these liabilities as the changes are immaterial measured as the change in fair value from movements in the period in the credit risk premium payable by the Group. The carrying amount is £365 million less than amortised cost.

24 Settlement balances and short positions

	Group 2005 £m	Group 2004 £m
Settlement balances amortised cost	6,561	4,067
Short positions held-for-trading:		
Debt securities Government	30,749	24,619
Other issuers	5,355	4,002
Treasury bills and other eligible bills	1,178	302
Equity shares	145	
	43,988	32,990

Notes on the accounts continued

25 Accruals, deferred income and other liabilities

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Notes in circulation	1,365	1,351		
Current taxation	952	662		18
Accruals	3,875	8,468	13	83
Deferred income	3,333	3,095		
Provisions for liabilities and charges (see table below)	162	198		
Other liabilities	4,560	3,874	1	200
	14,247	17,648	14	301
Amounts above include:				
Due to subsidiaries			1	150

(1) Other liabilities include £10 million (2004 £20 million) in respect of share-based compensation.

Provisions for liabilities and charges	Group		
	Property(1) £m	Other(2) £m	Total £m
At 1 January 2005	164	34	198
Currency translation and other movements	1	(1)	
Charge to income statement	7	7	14
Releases to income statement	(14)	(2)	(16)
Provisions utilised	(29)	(5)	(34)
At 31 December 2005	129	33	162

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.

26 Deferred taxation

Provision for deferred taxation has been made as follows:	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Deferred tax liability	1,695	2,061		
Deferred tax asset (included in Prepayments, accrued income and other assets, Note 20)	(156)	(47)	(3)	

Net deferred tax	1,539	2,014	(3)	—

	Group									
	Pension	Accelerated capital allowances	Provisions	Deferred gains	Other transition	Fair value of financial instruments	Intangibles	Hedging	Other	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January 2004 under UK GAAP	75	2,440	(686)	38	—	—	—	—	121	1,988
Implementation of IFRS (excluding IAS 32 and IAS 39)	(582)	(75)	—	109	7	—	243	—	(2)	(300)
At 1 January 2004 restated	(507)	2,365	(686)	147	7	—	243	—	119	1,688
Charge to income statement	(68)	419	2	(12)	(44)	—	(79)	—	66	284
Charge to equity directly	(424)	(6)	4	—	56	—	(2)	—	7	(365)
Acquisitions of subsidiaries	—	514	—	7	(6)	—	—	—	—	515
Other	—	(87)	22	—	—	—	—	—	(43)	(108)
At 1 January 2005	(999)	3,205	(658)	142	13	—	162	—	149	2,014
Implementation of IAS 32 and IAS 39	—	—	(24)	—	(288)	65	—	12	—	(235)
At 1 January 2005 restated	(999)	3,205	(682)	142	(275)	65	162	12	149	1,779
Charge to income statement	53	433	52	(21)	(52)	48	(18)	—	(125)	370
Charge to equity directly	(238)	—	—	—	—	(217)	—	(59)	(39)	(553)
Other	2	15	(34)	—	—	(4)	4	2	(42)	(57)
At 31 December 2005	(1,182)	3,653	(664)	121	(327)	(108)	148	(45)	(57)	1,539

	Company
	Total* £m
At 1 January 2004 and 1 January 2005	—
Implementation of IAS 32 and IAS 39	(5)
At 1 January 2005 restated	(5)
Charge to equity directly	2
At 31 December 2005	(3)

* All relates to hedging.

27 Insurance liabilities

	Group	
	2005 £m	2004 £m
Life assurance business:		
Unit linked insurance contracts	325	306
Other insurance contracts	1,974	1,735
Investment contracts	—	2,102
General insurance business	4,913	4,504
	7,212	8,647

General insurance business

(i) Claims and loss adjustment expenses

	Group		
	Gross £m	Reinsurance £m	Net £m
Notified claims	2,812	(481)	2,331
Incurred but not reported	1,087	(140)	947
At 1 January 2004	3,899	(621)	3,278
Cash paid for claims settled in the year	(3,198)	462	(2,736)
Increase in liabilities			
— arising from current year claims	3,943	(484)	3,459
— arising from prior year claims	(139)	217	78
Net exchange differences	(1)	(1)	(2)
At 31 December 2004	4,504	(427)	4,077

Notified claims	3,137	(296)	2,841
Incurred but not reported	1,367	(131)	1,236
At 1 January 2005	4,504	(427)	4,077
Cash paid for claims settled in the year	(3,474)	147	(3,327)