

ROYAL BANK OF SCOTLAND GROUP PLC

Form 20-F

March 29, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

(Mark

One)

.. **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, 2017

OR

..

**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**

Commission file number: 001-10306

THE ROYAL BANK OF SCOTLAND GROUP plc

(Exact name of Registrant as specified in its charter)

United Kingdom

(Jurisdiction of incorporation)

RBS Gogarburn, PO Box 1000, Edinburgh EH12 1HQ, United Kingdom

(Address of principal executive offices)

**Aileen Taylor, Chief Governance Officer and Board Counsel, Tel: +44 (0) 131 626 4099, Fax: +44 (0) 131 626
3081**

PO Box 1000, Gogarburn, Edinburgh EH12 1HQ

(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

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

Title of each class	Name of each exchange on which registered
American Depositary Shares, each representing 2 ordinary shares, nominal value £1 per share Ordinary shares, nominal value £1 per share	New York Stock Exchange*
American Depositary Shares Series S and U each representing one Non-Cumulative Dollar Preference Share, Series S and U respectively	New York Stock Exchange*
Dollar Perpetual Regulatory Tier 1 Securities	New York Stock Exchange
4.70% Subordinated Notes due 2018	New York Stock Exchange
5.625% Senior Notes due 2020	New York Stock Exchange
6.125% Senior Notes due 2021	New York Stock Exchange
6.125% Subordinated Tier 2 Notes due 2022	New York Stock Exchange
6.000% Subordinated Tier 2 Notes due 2023	New York Stock Exchange
6.100% Subordinated Tier 2 Notes due 2023	New York Stock Exchange
3.875% Senior Notes due 2023	New York Stock Exchange
3.498% Senior Notes due 2023	New York Stock Exchange
Senior Floating Rate Notes due 2023	New York Stock Exchange
5.125% Subordinated Tier 2 Notes due 2024	New York Stock Exchange
Leveraged CPI Linked Securities due January 13, 2020	NYSE MKT

* Not for trading, but only in connection with the registration of American Depositary Shares representing such ordinary shares or non-cumulative dollar preference shares, as applicable, pursuant to the requirements of the Securities and Exchange Commission.

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:

Perpetual Subordinated Contingent Convertible Additional Tier 1 Capital Notes callable 2020 Irish Stock Exchange

Perpetual Subordinated Contingent Convertible Additional Tier 1 Capital Notes callable 2021 Irish Stock Exchange

Perpetual Subordinated Contingent Convertible Additional Tier 1 Capital Notes callable 2025 Irish Stock Exchange

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of **December 31, 2017**, the close of the period covered by the annual report:

	(Title of each class)	(Number of outstanding shares)
Ordinary shares of £1 each		11,964,564,553
11% cumulative preference shares		500,000
5½% cumulative preference shares		400,000
Non-cumulative dollar preference shares, Series S and U		26,459,170
Non-cumulative euro preference shares, Series 1 to 3		2,044,418
Non-cumulative sterling preference shares, Series 1		54,442

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

Yes No

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.

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Yes No

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or an emerging growth company. See definition of "large accelerated filer", "accelerated filer", and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Emerging growth company

If an emerging growth company that prepares its financial statements in accordance with U.S. GAAP, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act:

The term "new or revised financial accounting standard" refers to any update issued by the Financial Accounting Standards Board to its Accounting Standards Codification after April 5, 2012.

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP

International Financial Reporting Standards as issued by the International Accounting Standards Board

Other

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If Other has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 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 No

SEC Form 20-F cross reference guide

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Forward-looking statements

Cautionary statement regarding 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, commit, believe, should, intend, plan, could, probability, risk, Value-at-Risk (VaR), target, goal, objective, may, endeavour, outlook, optimistic, prospects and similar expressions or variations on these expressions.

In particular, this document includes forward-looking statements relating, but not limited to: future profitability and performance, including financial performance targets such as return on tangible equity; cost savings and targets, including cost:income ratios; litigation and government and regulatory investigations, including the timing and financial and other impacts thereof; structural reform and the implementation of the UK ring-fencing regime; the implementation of RBS's transformation programme, including the further restructuring of the NatWest Markets franchise; the satisfaction of the Group's residual EU State Aid obligations; the continuation of RBS's balance sheet reduction programme, including the reduction of risk-weighted assets (RWAs) and the timing thereof; capital and strategic plans and targets; capital, liquidity and leverage ratios and requirements, including CET1 Ratio, RWA equivalents (RWAE), Pillar 2 and other regulatory buffer requirements, minimum requirement for own funds and eligible liabilities, and other funding plans; funding and credit risk profile; capitalisation; portfolios; net interest margin; customer loan and income growth; the level and extent of future impairments and write-downs, including with respect to goodwill; restructuring and remediation costs and charges; future pension contributions; RBS's exposure to political risks, operational risk, conduct risk, cyber and IT risk and credit rating risk and to various types of market risks, including as interest rate risk, foreign exchange rate risk and commodity and equity price risk; customer experience including our Net Promoter Score (NPS); sustainability matters, including targets; and employee engagement and gender balance in leadership positions.

Limitations inherent to forward-looking statements

These statements are based on current plans, estimates, targets and projections, and are subject to significant inherent risks, uncertainties and other factors, both external and relating to the Group's strategy or operations, which may result in the Group being unable to achieve the current targets, predictions, expectations and other anticipated outcomes expressed or implied by such forward-looking statements. In addition certain of these disclosures are dependent on choices relying on key model characteristics and assumptions and are subject to various limitations, including assumptions and estimates made by management. By their nature, certain of these disclosures are only estimates and, as a result, actual future gains and losses could differ materially from those that have been estimated. Accordingly, undue reliance should not be placed on these statements. Forward-looking statements speak only as of the date we make them and we expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Group's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Important factors that could affect the actual outcome of the forward-looking statements

We caution you that a large number of important factors could adversely affect our results or our ability to implement our strategy, cause us to fail to meet our targets, predictions, expectations and other anticipated outcomes or affect the accuracy of forward-looking statements we describe in this document, including in the risk factors and other uncertainties set out on pages 349 to 379 of this document and other risk factors and uncertainties discussed in this document. These include the significant risks for RBS presented by the outcomes of the legal, regulatory and governmental actions and investigations that RBS is or may be subject to and any resulting material adverse effect on RBS of unfavourable outcomes and the timing thereof (including where resolved by settlement); economic, regulatory and political risks, including as may result from the uncertainty arising from Brexit and from the outcome of general elections in the UK and changes in government policies; RBS's ability to satisfy its residual EU State Aid obligations and the timing thereof; RBS's ability to successfully implement the significant and complex restructuring required to be undertaken

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in order to implement the UK ring-fencing regime and related costs; RBS's ability to successfully implement the various initiatives that are comprised in its restructuring and transformation programme, particularly the proposed further restructuring of the NatWest Markets franchise, the balance sheet reduction programme and its significant cost-saving initiatives and whether RBS will be a viable, competitive, customer focused and profitable bank especially after its restructuring and the implementation of the UK ring-fencing regime; the dependence of the Group's operations on its IT systems; the exposure of RBS to cyber-attacks and its ability to defend against such attacks; RBS's ability to achieve its capital, funding, liquidity and leverage requirements or targets which will depend in part on RBS's success in reducing the size of its business and future profitability as well as developments which may impact its CET1 capital including additional litigation or conduct costs, additional pension contributions, further impairments or accounting changes; ineffective management of capital or changes to regulatory requirements relating to capital adequacy and liquidity or failure to pass mandatory stress tests; RBS's ability to access sufficient sources of capital, liquidity and funding when required; changes in the credit ratings of RBS, RBS entities or the UK government; declining revenues resulting from lower customer retention and revenue generation in light of RBS's strategic refocus on the UK; as well as increasing competition from new incumbents and disruptive technologies.

In addition, there are other risks and uncertainties that could adversely affect our results, ability to implement our strategy, cause us to fail to meet our targets or the accuracy of forward-looking statements in this document. These include operational risks that are inherent to RBS's business and will increase as a result of RBS's significant restructuring and transformation initiatives being concurrently implemented; the potential negative impact on RBS's business of global economic and financial market conditions and other global risks, including risks arising out of geopolitical events and political developments; the impact of a prolonged period of low interest rates or unanticipated turbulence in interest rates, yield curves, foreign currency exchange rates, credit spreads, bond prices, commodity prices, equity prices; basis, volatility and correlation risks; the extent of future write-downs and impairment charges caused by depressed asset valuations; deteriorations in borrower and counterparty credit quality; heightened regulatory and governmental scrutiny (including by competition authorities) and the increasingly regulated environment in which RBS operates as well as divergences in regulatory requirements in the jurisdictions in which RBS operates; the risks relating to RBS's IT systems or a failure to protect itself and its customers against cyber threats, reputational risks; risks relating to increased pension liabilities and the impact of pension risk on RBS's capital position, including on any requisite management buffer; risks relating to the failure to embed and maintain a robust conduct and risk culture across the organisation or if its risk management framework is ineffective; RBS's ability to attract and retain qualified personnel; limitations on, or additional requirements imposed on, RBS's activities as a result of HM Treasury's investment in RBS; the value and effectiveness of any credit protection purchased by RBS;

risks relating to the reliance on valuation, capital and stress test models and any inaccuracies resulting therefrom or failure to accurately reflect changes in the micro and macroeconomic environment in which RBS operates, risks relating to changes in applicable accounting policies or rules which may impact the preparation of RBS's financial statements or adversely impact its capital position; the impact of the recovery and resolution framework and other prudential rules to which RBS is subject; the application of stabilisation or resolution powers in significant stress situations; contribution to relevant compensation schemes; the execution of the run-down and/or sale of certain portfolios and assets; the recoverability of deferred tax assets by the Group; and the success of RBS in managing the risks involved in the foregoing.

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

The information, statements and opinions contained in this document do not constitute a public offer under any applicable legislation or an offer to sell or solicit of any offer to buy any securities or financial instruments or any advice or recommendation with respect to such securities or other financial instruments.

Presentation of information

In this document, and unless specified otherwise, the term **company** **Bank** or **RBSG** means The Royal Bank of Scotland Group plc, **RBS**, **RBS Group** or the **Group** means the company and its subsidiaries, the **Royal Bank** or **RBS plc** 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 , and the abbreviations m and bn represent millions and thousands of millions of euros, respectively.

Any information contained on websites linked or reports referenced in this annual report on Form 20-F is for information only and shall not be deemed to be incorporated by reference herein.

Segmental reporting

RBS continues to deliver on its plan to build a strong, simple and fair bank for both customers and shareholders. To support this, and in preparation for the UK ring-fencing regime, the previously reported operating segments were realigned in Q4 2017 and a number of business transfers completed, for full details see the Report of the directors.

RBS Group ring-fencing

The UK ring-fencing legislation requiring the separation of essential banking services from investment banking services will take effect from 1 January 2019.

To comply with these requirements it is RBS's intention to place the majority of the UK and Western European banking business in ring-fenced banking entities under an intermediate holding company. NatWest Markets Plc (NatWest Markets) will be a separate non ring-fenced bank and The Royal Bank of Scotland International (Holdings) Limited (RBSI Holdings) will also be placed outside the ring-fence, both as direct subsidiaries of RBSG.

On 1 January 2017, RBS made a number of key changes to the legal hierarchy of its subsidiaries to support the move towards a ring-fenced structure. As part of continuing preparation to deliver a fully compliant ring-fencing structure by 1 January 2019, it plans to undertake a further series of actions. For further details of these actions see the Report of the directors.

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Non-GAAP financial information

RBS prepares its financial statements in accordance with IFRS as issued by the IASB which constitutes a body of generally accepted accounting principles (GAAP). This document contains a number of non-GAAP (or non-IFRS) financial measures. A non-GAAP financial measure is defined as one that measures historical or future financial performance, financial position or cash flows but which excludes or includes amounts that would not be so adjusted in the most comparable GAAP financial measure.

The non-GAAP financial measures used in this document generally exclude certain items which management believe are not representative of the underlying performance of the business and which distort period-on-period comparison.

These measures are used internally by management, in conjunction with IFRS financial measures, to measure performance and make decisions regarding the future direction of the business. Management believes these non-GAAP financial measures, when provided in combination with reported IFRS results, provide helpful supplementary information for investors. These non-GAAP financial measures are not a substitute for and should be read in conjunction with reported IFRS financial measures.

The main non-GAAP financial measures used in this document include:

- Adjusted measures of financial performance, principally operating profit, operating expenses, total income and other performance measures before: own credit adjustments; gain or loss on redemption of own debt; strategic disposals, restructuring costs, litigation and conduct costs and write down of goodwill;
- Certain performance ratios based on the adjusted performance measures described above, including the adjusted cost:income ratio (calculated using adjusted operating income and costs), adjusted return on equity ratio (calculated using adjusted operating profit) and the 2017 cost saving progress and targets (calculated using operating expenses excluding litigation and conduct costs, restructuring costs, write down of goodwill, the impairment of other intangible assets, the operating costs of Williams & Glyn and the VAT recovery)
- Personal & Business Banking (PBB) franchise results, combining the reportable segments of UK Personal & Business Banking (UKPBB) and Ulster Bank RoI, Commercial & Private Banking (CPB) franchise results, combining the reportable segments of Commercial Banking and Private Banking (see page 109 for further details on segmental reporting including business descriptions and details of segmental reorganisation and business transfers); and

Reconciliations of these non-GAAP financial measures to the closest equivalent GAAP measure are presented throughout this document and in the 2017 performance on page 6.

Key operating indicators

This document includes a number of operational metrics which management believes may be helpful to investors in understanding the Group s business, including the Groups position against its own targets. These metrics include performance, funding and credit metrics such as return on tangible equity and related RWA equivalents incorporating the effect of capital deductions (RWAes), total assets excluding derivatives (funded assets) and net interest margin (NIM) adjusted for items designated at fair value through profit or loss (non-statutory NIM), cost:income ratio, loan:deposit ratio and REIL/impairment provision ratios. These are internal metrics used to measure business performance.

Capital and liquidity measures

Certain liquidity and capital measures and ratios are presented in this document as management believes they are helpful for investors understanding of the liquidity and capital profile of the business and the Group s position against its own targets and applicable regulatory requirements. Some of these measures are used by management for risk management purposes and may not yet required to be disclosed by a government, governmental authority or self-regulatory organisation. As a result, the basis of calculation of these measures may not be the same as that used by the Group s peers. These capital and liquidity measures and ratios include: the liquidity coverage ratio, stressed outflow coverage and

net stable funding ratio.

Presentation of information

Recent developments

Ring-fencing Transfer scheme

As announced on 22 March 2018, the Court of Session in Edinburgh has approved the application made in November 2017 to initiate the first Ring-fencing Transfer Scheme as detailed on page 108.

FX antitrust litigation

As previously disclosed, RBS is among the defendants in an FX-related antitrust class action on behalf of consumers and end-user businesses harmed by alleged collusion in the FX spot market. On 12 March 2018, the United States District Court for the Southern District of New York denied defendants' motion to dismiss the plaintiffs' amended complaint, holding that plaintiffs have adequately alleged antitrust standing, and denied defendants' request to take an immediate appeal from that decision. On 23 March 2018, the same court denied a motion by RBS and certain other defendants to dismiss the complaint for lack of personal jurisdiction.

In addition, as previously disclosed, RBS is among the defendants in a separate consolidated FX-related antitrust class action on behalf of indirect purchasers who were allegedly indirectly affected by FX instruments that others entered into with the defendant banks. On 15 March 2018, the United States District Court for the Southern District of New York granted RBS and the other defendants' motion to dismiss on a number of grounds, including failure to plead proximate cause and antitrust standing.

Interest rate hedging products litigation

As previously disclosed, Property Alliance Group (PAG) v The Royal Bank of Scotland plc was the leading case before the English High Court involving both interest rate hedging products (IRHP) mis-selling and LIBOR misconduct allegations. The amount claimed was £34.8 million and the trial ended in October 2016. In December 2016 the High Court dismissed all of PAG's claims. PAG appealed that decision, and the Court of Appeal's judgment was handed down on 2 March 2018. RBS was successful on all grounds. The decision (subject to any further appeal by PAG) may have significance for other similar IRHP and LIBOR-related cases currently pending in the English courts, some of which involve substantial amounts.

RMBS and other securitised products investigations

On 6 March 2018, the New York Attorney General announced that it had resolved its investigation of RBS's issuance and underwriting of residential mortgage-backed securities. RBS Financial Products Inc. will pay US \$100 million to the State of New York, and provide US \$400 million of consumer relief credits at a cost of approximately US \$130 million. The cost of the settlement is covered by existing provisions.

Governance and risk management consent order

As previously disclosed, in July 2011, RBS, RBS plc, and RBS N.V. agreed with the Board of Governors of the Federal Reserve System, the New York State Banking Department, the Connecticut Department of Banking, and the Illinois Department of Financial and Professional Regulation to enter into a consent Cease and Desist Order (the Order) to address deficiencies related to governance, risk management and compliance systems and controls in the US branches of RBS plc and RBS N.V. On 8 March 2018, the Federal Reserve Board announced that it had terminated RBS entities' obligations to the Federal Reserve Board under the Order. On 23 March 2018, the Illinois Department of Financial and Professional Regulation also notified RBS that it had terminated RBS entities' obligations to it under the Order.

2017 performance highlights

RBS reported an operating profit before tax of £2,239 million for 2017 and its first profit attributable to shareholders in ten years, of £752 million.

RBS delivered against its targets to increase income, reduce costs and use less capital across its businesses. In addition, RBS made substantive progress on resolving its remaining legacy issues. Net loans and advances growth of 2.2% across PBB, CPB and RBSI(1,2,3) was lower than target, however, the bank made greater progress than anticipated on RWA reductions.

Common Equity Tier 1 (CET1) ratio of 15.9% increased by 2.5 percentage points during 2017 and remains ahead of our 13% target.

We retain our target of achieving a sub 50% cost:income ratio and above 12% return on equity by 2020(4).

Note:

(1) Including the impact of transfers. See notes on page 16 for further details.

(2) Net loans and advances UK PBB up from £132.2 billion, 6.9% to £141.3 billion, Ulster Bank RoI up from £18.9 billion, 3.2% to £19.5 billion, Commercial Banking down from £100.1 billion, 4.9% to £95.2 billion, Private Banking up from £12.2 billion, 12.3% to £13.7 billion and RBSI down from £8.8 billion, 3.4% to £8.5 billion.

(3) Personal & Business Banking consists of the reportable segments UK Personal & Business Banking (UK PBB) and Ulster Bank RoI and Commercial & Private Banking consists of the reportable segments Commercial Banking and Private Banking. RBSI is a separate reportable segment.

(4) The targets, expectations and trends discussed in this section represent management's current expectations and are subject to change, including as a result of the factors described in this document and in the Risk Factors section on pages 349 to 379. These statements constitute forward looking statements; refer to Forward Looking Statements on pages 1 to 2 of this document

Notes:

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- (1) Including the impact of transfers. See notes on page 16 for further details.
- (2) Net loans and advances UK PBB up from £132.2 billion, 6.9% to £141.3 billion, Ulster Bank RoI up from £18.9 billion, 3.2% to £19.5 billion, Commercial Banking down from £100.1 billion, 4.9% to £95.2 billion, Private Banking up from £12.2 billion, 12.3% to £13.7 billion and RBSI down from £8.8 billion, 3.4% to £8.5 billion.
- (3) Personal & Business Banking consists of the reportable segments UK Personal & Business Banking (UK PBB) and Ulster Bank RoI and Commercial & Private Banking consists of the reportable segments Commercial Banking and Private Banking. RBSI is a separate reportable segment.
- (4) Based on end-point Capital Requirements Regulation (CRR) Tier 1 capital and leverage exposure under the CRR Delegated Act.
- (5) Refer to income statement reconciliations on page 6.
- (6) Criticality 1 incidents are defined as having an adverse impact on segment s customers, employees or third parties.
- (7) Operating expenses excluding litigation and conduct costs £1,285 million (2016 - £5,868 million), restructuring costs £1,565 million (2016 - £2,106 million), and VAT recoveries of £86 million (2016 - £227 million).
- (8) Operating expenses excluding litigation and conduct costs £1,285 million (2016 - £5,868 million), restructuring costs £1,565 million (2016 - £2,106 million). Operating lease depreciation included in income of £142 million (December 2016 - £141 million). Income excluding own credit adjustments £69 million loss (2016 £180 million gain), loss on redemption of own debt £7 million (2016 £126 million), and strategic disposals £347 million (2016 - £164 million).
- (9) Includes people supported through the following enterprise programmes during 2017: The Prince s Trust, Skills & Opportunities Fund and Entrepreneurial Spark.

Segmental summary income statements

	PBB	Ulster Bank	CPB		RBS	NatWest	Central items & other	Total
	UK							
	PBB	RoI	Commercial Banking	Private Banking	International	Markets		RBS
	£m	£m	£m	£m	£m	£m	£m	£m
2017								
Total income - statutory	6,477	604	3,484	678	389	1,050	451	13,133
Own credit adjustments		3				66		69
Loss on redemption of own debt							7	7
Strategic disposals						(26)	(321)	(347)
Total income - adjusted	6,477	607	3,484	678	389	1,090	137	12,862
Operating - statutory expenses	(3,829)	(676)	(2,014)	(529)	(219)	(2,201)	(933)	(10,401)
Restructuring - direct costs	79	27	48	20	5	319	1,067	1,565
- indirect	382	29	119	25	4	117	(676)	
Litigation and conduct costs	210	169	33	39	8	237	589	1,285
Operating expenses - adjusted	(3,158)	(451)	(1,814)	(445)	(202)	(1,528)	47	(7,551)
Impairment (losses)/releases	(235)	(60)	(362)	(6)	(3)	174	(1)	(493)
Operating profit/(loss) - adjusted	3,084	96	1,308	227	184	(264)	183	4,818
Additional information								
Return on equity (1)	23.7%	(5.0%)	6.6%	6.4%	11.2%	(9.0%)	nm	2.2%
Return on equity - adjusted (1,2)	30.7%	3.6%	8.2%	11.3%	12.6%	(3.7%)	nm	8.8%
Cost income ratio	59.1%	111.9%	56.0%	78.0%	56.3%	nm	nm	79.0%
Cost income ratio - adjusted (2)	48.8%	74.3%	50.0%	65.6%	51.9%	140.2%	nm	58.2%
2016								
Total income - statutory	6,127	576	3,415	657	374	1,212	229	12,590
Own credit adjustments		(3)				(187)	10	(180)
Loss on redemption of own debt							126	126
Strategic disposals						81	(245)	(164)
Total income - adjusted	6,127	573	3,415	657	374	1,106	120	12,372
Operating - statutory expenses	(4,276)	(669)	(2,467)	(549)	(174)	(2,824)	(5,235)	(16,194)
Restructuring - direct costs	46	38	25	7	2	75	1,913	2,106
- indirect	198	2	83	30	3	115	(431)	
Litigation and conduct costs	634	172	423	1		550	4,088	5,868
Operating expenses - adjusted	(3,398)	(457)	(1,936)	(511)	(169)	(2,084)	335	(8,220)
Impairment releases/(losses)	(125)	113	(206)	3	(10)	(253)		(478)
Operating profit/(loss) - adjusted	2,604	229	1,273	149	195	(1,231)	455	3,674
Additional information								
Return on equity (1)	16.2%	0.7%	4.1%	5.6%	13.8%	(12.5%)	nm	(17.9%)
Return on equity - adjusted (1,2)	25.1%	8.4%	8.4%	7.8%	14.2%	(8.7%)	nm	1.6%

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Cost income ratio	69.8%	116.1%	71.0%	83.6%	46.5%	nm	nm	129.0%
Cost income ratio - adjusted (2)	55.5%	79.8%	54.8%	77.8%	45.2%	188.4%	nm	66.0%
2015								
Total income - statutory	6,033	550	3,254	644	367	2,066	9	12,923
Own credit adjustments						(295)	(14)	(309)
Loss on redemption of own debt							263	263
Strategic disposals						38	119	157
Total income - adjusted	6,033	550	3,254	644	367	1,809	377	13,034
Operating - statutory expenses	(4,564)	(429)	(1,921)	(1,101)	(160)	(5,241)	(2,937)	(16,353)
Restructuring - direct costs	66	12	52	7		424	2,370	2,931
- indirect	129	3	17	66	4	1,407	(1,626)	
Litigation and conduct costs	972	(13)	51	12		404	2,142	3,568
Write down of goodwill				498				498
Operating expenses - adjusted	(3,397)	(427)	(1,801)	(518)	(156)	(3,006)	(51)	(9,356)
Impairment (losses)/releases	(8)	141	(69)	(13)		730	(54)	727
Operating profit/(loss) - adjusted	2,628	264	1,384	113	211	(467)	272	4,405
Additional information								
Return on equity (1)	13.5%	10.6%	9.8%	(27.7%)	18.5%	(11.2%)	nm	(4.7%)
Return on equity - adjusted (1,2)	25.3%	10.6%	10.9%	4.9%	18.9%	(3.0%)	nm	11.0%
Cost income ratio (3)	75.7%	78.0%	57.2%	171.0%	43.6%	nm	nm	126.9%
Cost income ratio - adjusted (2,3)	56.3%	77.6%	53.3%	80.4%	42.5%	166.2%	nm	71.4%

Notes:

(1) RBS's CET 1 target is 13% but for the purposes of computing segmental return on equity (ROE), to better reflect the differential drivers of capital usage, segmental operating profit after tax and adjusted for preference dividends is divided by average notional equity allocated at different rates of 14% (Ulster Bank RoI - 11% prior to 2017), 11% (Commercial Banking), 14% (Private Banking - 15% prior to 2017), 16% (RBS International - 12% prior to November 2017) and 15% for all other segments, of the monthly average of segmental risk-weighted assets incorporating the effect of capital deductions (RWAs). Return on equity is calculated using profit for the period attributable to ordinary shareholders.

(2) Excluding own credit adjustments, (loss)/gain on redemption of own debt, strategic disposals, restructuring costs, litigation and conduct costs and write down of goodwill.

(3) Operating lease depreciation included in income (year ended December 2017 - £142 million; year ended 31 December 2016 - £152 million).

Chairman's statement

Howard Davies

Chairman

2017 was another year in which we saw the bank move closer to achieving sustainable profitability.

Our share price increased 20% in the year, outperforming other main UK banks. We also welcomed the UK Treasury announcement in November 2017 to potentially restart the privatisation process by the end of March 2019. This announcement showed confidence in our strategic approach, the progress that we have made in making the bank safer and in a position to succeed as we approach a new era of disruption in banking.

The bank made an operating profit before tax of £2,239 million, and an attributable profit of £752 million⁽¹⁾, the first full year profit since 2007.

Progress in resolving legacy issues

We resolved a number of major legacy issues during the year. The Competition Directorate of the European Commission announced that it had agreed a revised scheme to satisfy the remaining State Aid obligations which were imposed on the bank in 2009. The new scheme replaces the need to divest the business formerly described as Williams & Glyn, and involves the creation of a capability fund to benefit challenger banks, alongside incentivised transfers of some of our small business customers. The scheme is not only practical, it will enhance competition.

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Another potentially damaging reputational risk was the 2008 Rights Issue litigation. That has now been resolved. The settlement announced in June 2017 brought the proceedings to an end.

In 2017 we continued with the run down of our non-core bank, with legacy risk weighted assets, excluding Alawwal(2), reducing by £12.6 billion in the year. Given its reduced scale, in December we announced the wind-up of this division, with the remainder of the assets now folded back mainly into NatWest Markets. We also settled an action with the Federal Housing Finance Agency related to this bank's participation in the US subprime mortgage market in the run up to the financial crisis.

There is, however, one major piece of litigation we need to resolve in relation to our past subprime mortgage activity, with the Department of Justice in the United States. At this point we cannot say when that issue will be closed, as the timing is not in our gift, but we continue to hope to resolve it in the coming months.

The treatment of some of our small business customers between 2008 and 2013 has been under scrutiny, and has received significant political and media attention. The Financial Conduct Authority (FCA) published a summary report into the historical operation of our former Global Restructuring Group (GRG) and the full report by Promontory was published by the Treasury Select Committee on 20 February 2017. The most serious allegations made against the bank in an earlier report by Dr. Lawrence Tomlinson were not upheld. Promontory stated that they did not find that defaults were engineered to transfer business simply to generate revenue for RBS. However, the bank was strongly criticised in the report and we acknowledge that we could have done better for many small business customers in GRG. I again apologise for the mistakes that were made during that time. The attitudes to customers displayed by some staff were not acceptable, and communication with clients was often poor. We have, as a result, refunded complex fees to many customers and established a complaints

Notes:

- (1) Profit attributable to ordinary shareholders.
- (2) NatWest Markets legacy RWAs 2017 - £14.0 billion (2016 - £26.6 billion); Alawwal RWAs 2017 - £6.6 billion (2016 - £7.9 billion).

Chairman's statement

scheme which is overseen by an independent third party - retired High Court judge Sir William Blackburne, who is working through our cases. The FCA have described this as an appropriate response to these findings. We have provided a sum of £400 million for these redress schemes.

Economy and Regulation

In 2017 the UK economy continued to grow, albeit below its long-term trend rate. Inflation is currently running at around 3%, above the Bank of England's 2% target. In its latest outlook the Bank of England has indicated that rates may have to rise somewhat sooner, and to a somewhat greater extent than they had previously anticipated. The Monetary Policy Committee believes that inflation will still be above target three years from now when they expect price pressures to be mounting, necessitating a monetary tightening.

Surveys of business confidence increasingly point to longer term uncertainty over how businesses will structure their operations, once the UK leaves the EU. The depreciation of sterling pushed up inflation but provided a boost to UK exporters, giving them the opportunity to reduce prices in overseas markets or to boost margins. With the International Monetary Fund (IMF) and Organisation for Economic Co-operation and Development (OECD) pointing to improving global growth prospects in 2018, the UK economy could gain from this favourable tailwind, albeit the scale of these gains is uncertain. In recent weeks, sterling has appreciated against the dollar, but remains weak against the euro.

In terms of regulation it was good to receive clarity on one of the most significant reforms following the financial crisis. The Basel Committee scrutinised the way in which banks assess risk on their balance sheet, with the aim of bringing more consistency and tighter controls. The impact on RBS of the package announced in December 2017 is likely to be small and we are well positioned for when the new rules come into force in 2022.

We are also on track to meet our ring-fencing obligations by 2019. The majority of the bank will be within the ring-fence, so I will chair the Boards of the Group and the ring-fenced bank. We are well advanced in the process of securing the legal permissions we need to transfer some of our customers to the most appropriate post ring-fenced legal entity. This will allow us to continue to serve them with little or no change to their day-to-day banking. The services they use (their local branch, sort code, account numbers and where relevant Relationship Manager) will not change as a result of the Ring-Fencing Transfer Scheme and they will not need to do anything differently.

Brexit

While there is some more clarity on the regulatory environment, the political context remains uncertain, especially in relation to Brexit. Since our business is largely UK-focused, the impact on RBS is not as significant as it is on many other banks. However, in common with them, we are preparing contingency plans to maintain our Western European business. One option is to use our existing banking licence in the Netherlands to provide continuity of service from NatWest Markets to our EU customers.

Changing customer behaviour and disruption

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Our operating environment is also changing. The UK financial services sector is experiencing its most significant period of disruption for some time. More accessible data, cheaper technology, new competition regulation and shifting customer expectations are the key drivers of change and are creating new challenges and opportunities for incumbent banks. These drivers are enabling new challenger banks to compete more effectively, from a lower cost base, and we have to respond. There will be more external partnerships with others than we have seen before as we offer new products and services. In 2017 we created a Technology and Innovation Committee of the Board to oversee and monitor RBS's strategic direction in what has become one of the most important areas of focus for the bank. The Committee is chaired by Alison Davis. Frank Dangeard and a new Board member, Yasmin Jetha, have also been appointed as members.

We also announced a significant reduction in our branch network. The decision to close a branch is always a difficult one to make, and is never taken lightly. However, customer behaviour is changing, with more customers choosing mobile and online over traditional branch counters, and we must respond to these changes. This shift in behaviour, combined with our partnership with the Post Office, mobile branches and Community Bankers, means there are now more ways to bank than ever before.

Our branches will remain key outlets for customers and we are investing in those that remain, to reflect the way customers want to use them, typically for financial advice related to buying a home or starting a business rather than for routine transactional banking.

Colleague engagement, diversity and inclusion

We are making good progress in improving the culture of the organisation. Our annual colleague sentiment survey scores are the highest they have been in ten years and there is generally a more positive outlook from colleagues across the bank.

In 2017 we were recognised as the Diverse Company of the Year at the National Diversity Awards; a Top 10 Employer for Working Families; a Times Top 50 Employer for Women and retained a gold rating for our work on Race in Business in the Community's Race for Opportunity benchmark. We also have a Black, Asian and Minority Ethnic (BAME) focus on recruitment, talent identification and promotion, and have introduced explicit targets for BAME representation at senior levels in 2018.

Today, for the first time, we have also published details of the average pay gap between male and female colleagues in the bank, which is 37.2%. Gender pay is markedly different to equal pay which looks at the difference in pay between men and women for similar roles. We are confident that we pay our employees fairly and keep our HR policies and processes under regular review to ensure we do so.

Our gender pay gap reflects an under representation of women at senior levels. That is not a satisfactory position and we know that we still have much to do to narrow the gap. We are therefore putting more impetus behind our work to achieve a better gender balance.

We are strongly committed to having more female colleagues in senior positions across the organisation. In 2015 we set ourselves a target to have at least 30% of roles in the three most senior levels of each of our businesses

filled by women by 2020. Our latest figures show we are now at 37% on aggregate, and on track to achieve 40% by 2020. Furthermore, 44% of our top 5000 roles are occupied by women and we are aspiring to achieve full gender balance at all levels of our business by 2030.

Building a sustainable bank

We are committed to running the bank as a more sustainable business, serving today's customers in a way that also safeguards future generations.

In 2017, RBS publicly committed to support the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) – a voluntary set of guidelines encouraging consistent climate-related disclosures in annual reporting. We also improved our position in a number of rankings – for example achieving 13th in top 100 organisations in the Stonewall Workplace Equality Index and maintained inclusion in the FTSE4GOOD index and high scores in the CDP climate index.

Our volunteering and fundraising partnerships also continue to make a difference for the communities we serve. In 2017, our employees supported a wide variety of charities by raising £4.3m in giving through their giving and fundraising efforts. We also won the Platinum award for Payroll Giving and the Payroll Giving Award for the Most Successful Sustained Scheme; 3,454 charities received funding.

Shareholder engagement

This year, we have increased the overall level of our non-financial disclosures in our Strategic report by featuring our performance highlights against each of our key influences we have described. We have introduced a new section, entitled Our Stakeholders, which describes our stakeholder groups and our approach to managing key topics of interest such as climate change.

As well as encouraging a more open culture internally, the Board has also made a considered effort to listen to the views of all shareholders. In 2017 we hosted two retail shareholder events in London and Edinburgh. Those events provided shareholders with the opportunity to share their views on our progress and our future initiatives directly with members of the Board and executive committee. Individual shareholders' views on our plans to build a better bank are important to us.

The Board has, during 2017, as in previous years, run a series of stakeholder engagement sessions with representatives from a wide variety of different organisations to discuss key topics such as financial capability and technological disruption with members of our Board and senior executives. This is helping us to make better informed decisions and ensure our future strategy addresses emerging sustainability risks and opportunities. We will continue to run these events in future years. Board members have also visited business customers, and will undertake more such visits around the country this year.

Board Changes

In 2017 Mark Seligman and Yasmin Jetha joined the Board and have already brought a wealth of experience and fresh perspectives to our discussions. Mark became the Senior Independent Director at the end of the year. Sadly, John Hughes, who joined in June 2017, had to step down in September 2017 for health reasons. Dr Lena Wilson was appointed as a non-executive director on 1 January 2018. Lena brings strong commercial and public sector experience to the Board, having previously served as Chief Executive of Scottish Enterprise and Senior Investment Advisor to The World Bank. With effect from 1 January 2018, Sandy Crombie stepped down from the Board and Penny Hughes has told us that she does not plan to stand for re-election at the 2018 Annual General Meeting. I would like to thank both Sandy and Penny for their outstanding commitment and huge contributions to RBS over a number of years. Sandy was, as Senior Independent Director, a great support to my predecessor and to me. Penny has led the Remuneration and, later, the Sustainable Banking Committee with great enthusiasm. We wish them both well for the future.

Conclusion

Overall, the Board believes that in 2017 we have made further progress in resolving the legacy issues which have hung over the bank for too long. We still have important issues to resolve and tough decisions to make, particularly on cost control, but in 2017 we made several important steps in the right direction. Thank you for your patience as we continue the bank's turnaround.

Chief Executive's review

Ross McEwan

Chief Executive

Putting the past behind us. Investing for the future.

In 2017 we continued to make good progress in building a simpler, safer and more customer focused bank. I am pleased to report to shareholders that the bank made an operating profit before tax of £2,239 million in 2017, and for the first time in ten years we have delivered a bottom line profit of £752 million(1).

We have achieved profitability through delivering on the strategic plan that was set out in 2014. The first part of this plan was focused on building financial strength by reducing risk and building a more sustainable cost base. So far, we have reduced our risk-weighted assets by £228 billion and today can report a Common Equity Tier 1 ratio of 15.9% up from 8.6% in 2013. Our financial strength is now much clearer. Over the same period we have reduced operating costs by £3.9 billion(2). We still have more to do on cost reduction, however this reflects the progress we have made in making the bank more efficient.

A clear indication of the outstanding progress we have made is that from the first quarter of 2018, we will no longer report adjusted financials.

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At the same time as building financial strength, we have also made progress with the legacy of our past and improving our core bank. We have delivered on this by resolving a number of our litigation and conduct issues. This includes reaching settlements last year with FHFA in respect of our historical Retail Mortgage Backed Securities (RMBS) activities and with claimants in relation to our 2008 Rights Issue. In 2017 we also continued to run down our legacy assets. The wind-up of our non-core division, Capital Resolution in 2017, was an important moment.

As part of the support we received in 2008 and 2009, the bank was mandated to meet certain requirements under a State Aid restructuring plan. In 2017, we received approval for an alternative remedies package, which replaced our original plan to divest of the business formally known as Williams & Glyn. This is a good solution, both for improving competition in the UK SME banking market, and for shareholders.

With this solution in place and currently being implemented, the number of legacy issues the bank faces has reduced. However, we have one major legacy issue that we have yet to resolve which is with the US Department of Justice. The timing of the resolution of this issue is not in our control.

Notes:

- (1) Profit attributable to ordinary shareholders.
- (2) Operating expenses excluding litigation and conduct costs, restructuring costs, write-down of goodwill, restructuring costs associated with the business formerly described as Williams & Glyn.

The bank has received significant media attention for its treatment of some small business customers between 2008 and 2013. To those customers who did not receive the experience they should have done while in GRG we have apologised. We accept that we got a lot wrong in how we treated customers in GRG during the crisis. However, these were complex and subjective cases with each case having unique facts about what was the right thing to do. The bank welcomes the FCA's confirmation that the most serious allegations made against the bank have not been upheld and that the steps the bank announced in November 2016 to put things right for customers are appropriate.

We have made significant progress in improving our culture since then.

Today this bank is a simpler and safer organisation, with colleagues now fully focused on our customers.

I want to thank our colleagues for their commitment and resolve during what has been a difficult chapter in the bank's history. Our most recent colleague survey, *Our View*, reported the highest engagement levels in ten years. We also recently won the Employee Engagement Company of the Year at the UK Employee Engagement Awards. This shows that our culture is improving. This bank is now more open, less hierarchical and more focused on our customers. Our colleagues serve and support millions of customers across the UK and Republic of Ireland every day, it is vital to our success that they feel engaged and motivated.

Investing to transform our business

When I started as CEO in 2014 the bank was far too complex. We operated in 38 countries, with over 5,000 systems supporting hundreds of different products. In our credit card business alone we offered 55 different card designs, as the organisation had grown we had added complexity which distracted us from our key stakeholder, the customer. Our customers want a bank which protects their safety and security, and is also responsive to their needs.

Today we have exited 26 countries and now have a more focused product set, underpinned by almost half the number of systems we previously had. Simplification will continue to be a key focus for the organisation in 2018.

We are going through all of our end-to-end customer processes to ensure they are fit for purpose.

Our mortgage application journey is experienced by thousands of customers every day. With one of our strategic aims being to grow in this market, the benefits of simplification and automation in this area are vast. Given this, in 2017 NatWest was the first UK bank to offer paperless mortgages. Customers can now apply for a completely digital mortgage which uses the latest technology to securely share and verify documents online. With this new proposition, mortgage offers can now be made within 11 days, down from 23 days before. The process also eliminates close to 4.3 million sheets of paper a year, reducing our impact on the environment.

The opportunities created by greater simplification and automation, in terms of improved controls, cost reduction and a better customer experience, are significant for this bank.

As well as transforming our processes and products, in 2017 we continued to reap the benefits of refocusing our main customer-facing brands. With each now speaking to a unique constituency of customers, we are better placed to differentiate ourselves from our competitors. With NatWest for England and Wales, Royal Bank of Scotland, for Scotland and Ulster Bank for the island of Ireland we truly are a bank of brands in the UK and the Republic of Ireland.

Customer driven change

Listening and responding to our customers is helping us to get closer to meeting our goal to be No.1. In light of this we have continued with the roll out of Closed Loop Feedback in 2017. Today, within 24 hours of an interaction taking place, customers can provide specific, actionable feedback directly to the teams that serve them, empowering colleagues to listen, learn from and act on what our customers are telling us. With our complaints volumes down 9% on the previous year, and our Net Promoter scores improving in half of our chosen customer segments, we continue to see the benefits of customer driven change in this bank. We still have a lot of work to do to meet our 2020 ambition of being the number one bank for customer service, trust and advocacy.

Listening to our customers is not only reducing complaints, it is also driving product and service improvements. In our commercial bank for instance, in response to customers' demand for greater speed and efficiency, we have developed self service account opening. Through this channel more than 90% of our new to bank commercial customers are able to initiate account openings themselves and, crucially, are doing it 30 minutes faster than if they used telephony. Customers told us this was a pain point for them and we have responded.

Listening to our customers and investing to simplifying our processes is helping us build a bank which is lower cost, and competitive in our target markets - improving outcomes for both customers and shareholders.

We are committed to running the bank as a more sustainable business, serving today's customers in a way that also helps future generations. As technological, social and environmental changes shape the world, it is important to stay connected with evolving customer needs, our shareholders and the wider expectations of society. One of the ways in which we are doing this is through our Board-level stakeholder engagement programme where we proactively listen, learn and engage with our stakeholders to improve the way we do business.

Supporting the UK economy

While transforming the bank, we have continued to support the UK economy. In 2017 we extended £33.9 billion in new mortgage lending, helping grow our mortgage market share for the fifth consecutive year. We continue to target growth in our mortgage market share in 2018.

We are also the biggest supporter of UK business. Our commercial bank grew lending in our target markets, this commitment supported both recognised household names and fledgling start-ups. Our commitment to business goes beyond simple financing, our Entrepreneurial Spark programme continued to grow in 2017 and has supported over 3,800 new businesses since 2012 with award-winning facilities and an outstanding support network. Our work is also being recognised externally. In 2017 NatWest was awarded Best Business Bank in the UK by the National Association of Commercial and Finance Brokers.

Chief Executive's review

Throughout 2017 NatWest Markets has continued to deepen its customer relationships by providing global market access and innovative and tailored solutions. As well as increasing employee engagement and improving the control environment, the business has made material progress to realise cost and operating efficiencies.

Responding to technological change

The financial services industry is going through one of the most significant periods of change we have seen in many years, and we are responding.

Like other industries, the digital revolution has naturally led to lower footfall in our branches. Branch transactions are down 40% on 2013, as increasingly our customers prefer the convenience and ease of digital banking. Given this we have made some difficult, but necessary, decisions around the scale of our branch network in 2017. This does not mean we are not supporting our customers. In fact we are providing customers more ways to bank than ever before, be that through a visit to their local Post Office, a visit from one of our 39 mobile branches, which visit over 600 towns and villages on a weekly basis, meeting one of our 100 community bankers, a digital appointment with one of our video bankers, logging on to internet banking platform, or banking on the go with our market leading mobile app. Our customers have never had as many channels through which to undertake their banking.

For the first time we now have more active mobile users than users online, a clear indication of the direction of travel of our customers' banking preferences.

Our ambition is for the standard of service we provide to always be outstanding, no matter how our customers choose to interact with us. In 2018 our branches will increasingly focus providing specialised expertise and advice as well as on helping customers tap into the wealth of ease and efficiency they can experience through using our digital channels.

In our commercial bank, we are supporting customers shift to mobile through building our online service Bankline service into an app. Currently, 90,000 commercial customers are active on Bankline. In the future we expect this to move increasingly to mobile. In 2018, we will also launch Bankline mobile for our larger commercial customers. This new service will act as a companion to our current Bankline on-line technology. Initially, customers will be able to view transactions and send payments with biometric approval. In the coming quarters we will further expand the scope of what Bankline Mobile offers.

Embracing the latest in digital innovation

We know that we cannot stand still on innovation as our competitors certainly are not. Over the last few years we have invested in building our partnerships and scouting networks across the globe to ensure we are at the cutting edge of technology. We have developed some excellent partnerships and one area we have advanced significantly in is Artificial Intelligence (AI).

By harnessing the latest in computer learning and speech recognition, in partnership with IBM, we have built an AI chatbot, called Cora. Cora is helping our customers with many of their most common queries. Crucially Cora is available 24/7, has no wait-time to serve a customer and can handle an unlimited number of queries at the same time. Since Q1 2017 Cora has handled over four hundred thousand conversations responding to over two hundred different questions.

In partnership with Soul Machines, we are investing now to build an evolution of Cora for 2018, giving her a visual avatar acting as the interface with our customers. Initial trials are proving a success with customers telling us that using Cora made them less concerned about converting to our other digital channels. While many customers felt empowered to be more direct in their questioning of Cora, as they felt much safer and more secure with her.

Through digital innovation we will serve customers more efficiently, be more responsive to their needs and at the same reduce costs in the business and build a more solid control environment.

Looking forward

In the past our legacy has dominated our corporate story. In 2017 our financial strength improved and we continued to put the past behind us. We are entering a new phase of transforming the core bank through technology innovation and end-to-end process re-engineering. Our future will be high tech and high touch, which means lower cost, high quality digital services with human expertise available when required.

Conclusion

I would like to thank shareholders for their continued support. We welcome the indication in the Chancellor's budget statement about the potential to restart share sales during the fiscal year 2018/2019, again this is a further proof of the progress we have made.

We recognise our responsibility towards the society we serve and operate in. It is only by supporting our customers and communities to succeed that we will become a more sustainable bank. I, together with my management team, view this as a core part of our ambition to be No.1 for customer service, trust and advocacy.

As the number of our legacy issues reduces, and our business performance improves, the investment case for this bank is clearer, and the prospect of us rewarding our shareholders is getting closer.

In 2017 we continued to make good progress in building a simpler, safer and more customer focused bank.

2017 performance summary

RBS reported its first profit attributable to shareholders in ten years

- 2017 operating profit before tax of £2,239 million, an increase of £6,321 million compared with 2016.
- Adjusted operating profit before tax^(1,2) increased by 31.1% to £4,818 million.
- 2017 profit attributable to shareholders of £752 million.
- 4.3% increase in income (4.0% increase in adjusted income⁽¹⁾) and a 35.8% reduction in operating expenses (8.1% reduction in adjusted operating expenses⁽²⁾).
- Net interest margin (NIM) reduced by 5 basis points to 2.13% compared with 2016.
- Supported the UK economy through a £6.0 billion, or 2.2%^(3,4), increase in net lending across PBB, CPB and RBSI⁽⁵⁾. Whilst behind our 3% target, this represents strong growth in a competitive environment.

Delivery against our 2017 targets

Notes:

(1) Income excluding own credit adjustments £69 million loss (2016 - £180 million gain), loss on redemption of own debt £7 million (2016 - £126 million) and strategic disposals £347 million (2016 - £164 million).

(2) Operating expenses excluding litigation and conduct costs £1,285 million (2016 - £5,868 million), restructuring costs £1,565 million (2016 - £2,106 million) and VAT recoveries of £86 million (2016 - £227 million).

(3) Including the impact of transfers. See notes on page 16 for further details.

(4) Net loans and advances UK PBB up from £132.2 billion, 6.9% to £141.3 billion, Ulster Bank RoI up from £18.9 billion, 3.2% to £19.5 billion, Commercial Banking down from £100.1 billion, 4.9% to £95.2 billion, Private Banking up from £12.2 billion, 12.3% to £13.7 billion and RBSI down from £8.8 billion, 3.4% to £8.5 billion.

(5) Personal & Business Banking consists of the reportable segments UK Personal & Business Banking (UK PBB) and Ulster Bank RoI and Commercial & Private Banking consists of the reportable segments Commercial Banking and Private Banking. RBSI is a separate reportable segment.

Continued track record of delivery against our stated objectives

§ **Grow income:** Total income increased by £543 million or 4.3%. Adjusted income increased by £490 million(1), or 4.0%.

§ **Cut costs:** Operating expenses reduced by £5,793 million or 35.8%. Excluding VAT recoveries of £86 million (2016 - £227 million), adjusted operating expenses reduced by £810 million(1,2), or 9.6%.

§ **Reduce capital usage:** Taking into account the impact of volume growth, RWAs reduced by £20.8 billion across PBB (£0.6 billion), CPB (£12.9 billion), RBSI (£4.4 billion) and NatWest Markets core (£2.9 billion), already achieving our 2018 target.

§ **Resolve legacy issues:**

During 2017, RBS:

Wound up the former Capital Resolution business. Legacy RWAs now represent around 11% of total;

Received formal approval from the European Commission for its alternative remedies package in respect of the business previously described as Williams & Glyn; and

Reached settlement with the Federal Housing Finance Agency (FHFA) and the California State Attorney General in the US and resolved the 2008 rights issue shareholder litigation.

Significant capital build throughout 2017

§ CET1 ratio increased by 250 basis points to 15.9%, despite absorbing significant additional legacy costs.

§ IFRS 9 adoption on 1 January 2018 increased CET1 by a further 30 basis points.

Prioritising transformation acceleration

§ Increased investment and innovation spend focused on achieving higher levels of digitisation and automation.

§ Faster repositioning of the bank's existing distribution network and technology platforms towards mobile, cloud based platforms and virtualisation.

Building a more sustainable bank

§ Our Board Sustainable Banking Committee hosted four stakeholder engagement sessions, inviting a broad mix of stakeholders to share their perspective on key issues with us.

§ RBS is a founding partner with the National Trading Standards Scam Team on their Friends Against Scams initiative.

§ RBS was recognised by InfraDeals as the leading lender to the UK renewables sector by number of transactions over the past six years (2012- 2017).

§ We helped over one million customers with a free Financial Health Checks to help customers organise their finances and achieve their financial goals.

§ We supported over 3,830 people through our enterprise programmes. This includes the following enterprise programmes: Entrepreneurial Spark, Prince s Trust and Skills & Opportunities Fund.

Notes:

(1) Refer to income statement reconciliations on page 6.

(2) Operating expenses excluding litigation and conduct costs £1,285 million (2016 - £5,868 million), restructuring costs £1,565 million (2016 - £2,106 million) and VAT recoveries of £86 million (2016 - £227 million).

UK Personal & Business Banking

§ UK PBB now includes the business previously described as Williams & Glyn. Operating profit of £2,413 million was 40% higher than in 2016 including a £185 million debt sale gain. Adjusted operating profit(5) of £3,084 million was 18.4% higher than in 2016. Income increased by 5.7% to £6,477 million supported by a 5.9% increase in net loans and advances, which more than offset margin contraction. Operating expenses were 10.5% lower than 2016 reflecting lower litigation and conduct costs, down 67%, partially offset by restructuring costs, up 89%. Return on equity increased to 23.7% from 16.2% in 2016. Adjusted operating expenses(5) were 7.1% lower than 2016 reflecting reduced headcount and lower back-office operations costs. Adjusted return on equity(5) increased to 30.7% in 2017 from 25.1% in 2016. There are a range of variables that could impact near to medium term returns, including RWA inflation as a result of a change in Bank of England mortgage risk weighting.

§ Gross new mortgage lending was £31.0 billion, with market share of new mortgages at approximately 12%, supporting growth in stock share to approximately 10%. Mortgage approval share in Q4 2017 decreased to approximately 12%, from around 14% in Q3 2017, and mortgage new business margins were 14 basis points lower in the quarter, in part reflecting intense price competition in the market.

§ UK PBB continues to invest in its digital offering and now has 5.5 million customers regularly using its mobile app, 20% higher than December 2016, and in 2017 was the first bank to launch a paperless mortgage journey.

Ulster Bank RoI

§ Ulster Bank RoI reported an operating loss of £132 million (151 million), an adjusted operating profit(5) of £96 million (109 million) and a return on equity of (5.0%). Adjusted return on equity was 3.6 %(5) in 2017. Total income increased by £28 million, or 4.9%. In euro terms, total income decreased by 15 million, or 2.1%., primarily reflecting a reduction in income on free funds, partially offset by one-off items, higher lending income and reduced funding costs. Adjusted income(5) increased by £34 million or 5.9% and in in euro terms decreased by 8 million, or 1.1%

§ Gross new lending increased by 7.2% from £2.1 billion in 2016 to £2.3 billion (by 3.4% from 2.5 billion in 2016 to 2.6 billion in euro terms). Total expenses increased by £7 million (46 million decrease). Further cost efficiencies have been achieved, with adjusted expenses(5) reducing by £6 million (43 million) in 2017.

§ Ulster Bank RoI was amongst the first banks in Ireland to introduce Apple Pay and Android Pay, and now over 70% of our customers are actively using our digital proposition, increased from 58% of our active customer base in 2016. We continue to reposition capital, with REILs down by 5.7% to £3.3 billion (9.8% to 3.7 billion), representing 16.0% of gross customer loans, compared with 17.5% in 2016.

Commercial Banking

§ Commercial Banking includes selected assets from the former Capital Resolution business from 1 October 2017. Operating profit of £1,108 million was 49.3% higher compared to 2016 and return on equity was 6.6% compared to 4.1%. Adjusted operating profit(5) of £1,308 million was 2.7% higher than 2016 and adjusted return on equity(5) remained broadly stable at 8.2%. Income increased by 2.0% due to increased volumes in targeted segments and deposit re-pricing benefits.

§ Operating expenses decreased by £453 million to £2,014 million. Adjusted operating expenses(5), reduced by 6.3% reflecting operating model simplification and productivity improvements, including a 16.4% reduction in front office headcount. Commercial Banking net impairment losses of £362 million increased by £156 million and reflecting a small number of single name impairments.

§ Net loans and advances decreased by £3.1 billion to £97.0 billion. Adjusting for transfers (1) net lending decreased by £4.9 billion in 2017, as growth in targeted segments has been more than offset by active management of the lending book, achieving gross RWA reductions of £12.5 billion.

§ With the successful launch of our entrepreneur accelerator hub in London we now have 12 business accelerators throughout the UK. Across these hubs, over 3,800 start ups have benefitted from our support, which has helped them raise £255 million of investment while creating over 8,000 jobs.

Private Banking

§ Private Banking now includes the Collective Investment Funds business transferred from UK PBB on 1 October 2017. Operating profit increased by £32 million, or 28.8%, to £143 million compared with 2016 and return on equity increased from 5.6% to 6.4%. Adjusted operating profit(5), increased by £78 million, or 52.3%, to £227 million and adjusted return on equity(5) increased to 11.3% from 7.8%. Total income increased by £21 million to £678 million. Adjusting for transfers of £9 million, income increased by £12 million due to higher lending volumes and an £8 million gain on a property sale, partially offset by margin pressure.

§ Operating expenses decreased by 3.6%. A 12.9% reduction in adjusted operating expenses(5), was supported by an 11.8% reduction in front office headcount.

§ Net loans and advances increased by 10.7% to £13.5 billion and assets under management increased by 14.4%, after adjusting for transfers(2)

§ We continue to focus on delivering the best customer experience, including investing in digital by launching Coutts Invest and an enhanced mobile experience, and we were awarded Best Private Bank in the UK at the Global Private Banking Awards 2017.

RBS International (RBSI)

§ RBSI reported an operating profit of £167 million, 12.1% lower than 2016 and return on equity decreased to 11.2% from 13.8%. Adjusted operating profit(5), of £184 million, was 5.6% lower than 2016. Income increased by 4.0% driven by increased lending and deposit volumes and re-pricing actions on the deposit book.

§ Operating expenses increased by 25.9% compared with 2016. Return on equity decreased to 11.2% from 13.8%. Adjusted operating expenses(5), increased by 19.5% reflecting increased operational costs associated with becoming a non ring-fenced bank. Despite this, adjusted return on equity remained robust at 12.6%.

§ RWAs of £5.1 billion reduced by £4.4 billion compared with 2016 reflecting the benefit of receiving regulatory approval for RBSI to adopt an advanced internal ratings based approach on the wholesale corporate book.

NatWest Markets

§ Following the closure of the former Capital Resolution business in Q4 2017, NatWest Markets now includes legacy run-off assets alongside its core businesses. An operating loss of £977 million was reported in 2017, including a profit of £41 million in the core business. Adjusted operating loss(5) of £264 million, compared with £1,231 million in 2016. Total income decreased by £162 million, or 13.4%, to £1,050 million. Adjusted income(5) in the core business increased by 9.5% to £1,665 million, largely driven by Rates as the business navigated markets well.

§ Legacy disposal losses, other adjustments and impairments of £513 million were incurred in 2017, compared with £825 million in 2016. Operating expenses of £2,201 million were £623 million, or 22.1%, lower than 2016, whereas adjusted operating expenses(5) reduced by 26.7% reflecting a significant reduction in the legacy business, as it moved towards closure, and cost reductions in the core business. RWAs decreased by £15.3 billion, adjusting for transfers(3), to

§ £52.9 billion primarily reflecting legacy business reductions. At the end of 2017 the legacy business within NatWest Markets had RWAs of £14.0 billion, excluding RBS's stake in Alawwal Bank, a reduction of £10.9 billion, adjusting for transfers(3), over the course of the year.

Notes:

(1) Shipping and other activities which were formerly in Capital Resolution were transferred from NatWest Markets on 1 October 2017, including net loans and advances to customers of £2.6 billion and RWAs of £2.1 billion. Commercial Banking transferred whole business securitisations and relevant financial institutions (RFI) to NatWest Markets during December 2017, including net loans and advances to customers of £0.8 billion and RWAs of £0.6 billion. Comparatives were not re-presented for these transfers.

(2) UK PBB Collective Investment Funds (CIFL) business was transferred from UK PBB on 1 October 2017, including total income in Q4 2017 of £11 million and assets under management of £3.3 billion. Private Banking transferred Coutts Crown Dependency (CCD) to NatWest Markets during Q4 2017, including total income of £2 million and assets under management of £1.3 billion. Comparatives were not re-presented for

these transfers.

(3) Shipping and other activities which were formerly in Capital Resolution were transferred to Commercial Banking on 1 October 2017, including RWAs of £2.1 billion. Whole business securitisations and relevant financial institutions (RFI) were transferred from Commercial Banking during December 2017, including RWAs of £0.6 billion. Comparatives were not re-presented for these transfers.

(4) Transfers include £0.4 billion loans and advances transferred from Commercial Banking to UK PBB during 2017 to better align Business banking customers. Comparatives were not re-presented for these transfers.

(5) Refer to income statement reconciliations on page 6.

2017 performance summary

Looking forward

2018 Outlook(1)

We reiterate our medium term outlook on both return on tangible equity and cost:income ratio. We also now intend to accelerate the transformation of the bank which necessitates increased investment and innovation spend together with additional restructuring costs. As a result operating costs, excluding restructuring and litigation and conduct costs, will reduce compared with 2017, but the rate of cost reduction will be materially lower than in 2017. We expect to incur restructuring charges of around £2.5 billion across 2018 to 2019 cumulatively, of which c.£0.3 billion relates to the completion of the State Aid remedy and reintegration of the former Williams & Glyn (W&G) business into UK PBB. This is compared to previous guidance of around £1 billion excluding the impact of W&G, with around two thirds of the remaining c.£1.2 billion increase being driven by costs associated with the accelerated transformation.

RBS continues to deal with a range of significant risks and uncertainties in the external economic, political and regulatory environment and manage both conduct-related investigations and litigation, including relating to RMBS. Substantial additional charges and costs may be recognised in the coming quarters.

With the introduction of IFRS 9, impairments are expected to be more volatile and we continue to remain mindful of potential downside risks, particularly from single name and sector driven events. The consensus view of Brexit suggests a weaker UK economy in the short to medium term. With the current high level of UK household debt and real wage compression, any increases in unemployment and interest rates present a threat to retail impairment rates. In wholesale portfolios further softening of GDP growth would be expected to impact credit losses negatively. We retain our guidance that through the cycle losses would be in the range of 30-40bps.

By the end of 2018, we expect Bank RWAs to be lower by £5-10 billion. This is despite model uplifts in Commercial Banking in 2018 which are expected to drive some RWA inflation. The majority of the gross RWA reductions will be within NatWest Markets legacy assets, including the benefit of the anticipated merger between Alawwal Bank and Saudi British Bank, and Commercial Banking.

RBS Group capital and funding issuance plans for 2018 focus on issuing £4-6 billion MREL-compliant securities. We do not currently anticipate the need for either AT1 or Tier 2 issuances. As in 2017, we will continue to target other funding markets to diversify our funding structure. In support of the ring-fencing requirements and to build up RBS Plc (to be renamed NatWest Markets Plc) as a standalone non ring-fenced bank, we anticipate

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issuing £2-4 billion of senior unsecured issuance from this entity in addition to continued reliance on short term funding.

In the near to medium term, we would expect the bank to maintain a CET1 ratio in excess of our 13% target given a range of variables that are likely to impact us over the coming years. These include:

- § potential final costs of a resolution with the US Department of Justice;
- § future potential pension contributions and the interplay with capital buffers for the bank for investment risk being run in the pension plan;
- § RWA inflation as a result of IFRS 16, Bank of England mortgage floors and Basel 3 amendments;
- § expected increased and pro-cyclical impairment volatility as a result of IFRS 9; and
- § the collective impact of these items on our stress test results.

We remain committed to restarting capital distributions when permitted, with resolution with the US Department of Justice being a key milestone to enable this.

Medium term outlook

We retain our target of achieving a sub 50% cost:income ratio and above 12% return on equity by 2020.

While we expect operating costs to reduce each year from 2018 to 2020, given the increased level of investment and innovation spend expected over the coming years we are no longer guiding to an absolute 2020 cost base.

The NatWest Markets segment balance sheet as at end 2017 is broadly similar to the expected target balance sheet of the NatWest Markets Plc after the ring- fence transfer schemes to be carried out during 2018. In preparation for the UK ring-fencing regime, the previously reported operating segments were realigned in Q4 2017 and a number of business transfers completed. These changes included the NatWest Markets segment absorbing the former Capital Resolution segment (other than for certain shipping and portfolio assets). Notwithstanding a planned capital reduction exercise in July 2018, by 2020 this entity is targeting a capital base with a consolidated end state CET1 of 14%, a leverage ratio greater than 4% and a total capital ratio of at least twice the CET1 ratio, including the benefit of downstreamed internal MREL.

By 2020, NatWest Markets targets a RWA position of c.£35 billion including legacy assets, with the legacy assets generating minimal associated income, and an overall cost base of around £1 billion.

Trading update

Overall, RBS has had a positive start to 2018.

Note:

(1) The targets, expectations and trends discussed in this section represent management's current expectations and are subject to change, including as a result of the factors described in this document and in the Risk Factors on pages 349 to 379. These statements constitute forward looking statements, refer to Forward Looking Statements on pages 1 to 2.

Our business model and strategy

Our Strategy

Our ambition is to become number one for customer service, trust and advocacy as we meet the aspirations and needs of our retail, business, commercial, corporate and institutional customers. Our core businesses are centred around the UK and Republic of Ireland markets with a focused international capability.

We are building a better bank for our customers, and one that will deliver sustainable returns for shareholders. Our purpose is to serve customers well, and to do so, we are becoming a safe, simple, customer-focused UK and Ireland bank.

Our plan

Underpinning that ambition is our blueprint for success. This is our plan which drives our strategic decision making.

RBS is continuing to build a bank that is easy to do business with, and meets customers' continually evolving needs.

Our plan focuses on delivering excellent customer service through all of our brands.

Creating lasting relationships with our customers, who advocate for our bank, is the key to generating sustainable value.

Note:

(1) The goals, expectations and trends discussed in this section represent management's current expectations and are subject to change, including as a result of the factors described in this document and in the Risk Factors section on pages 349 to 379. These statements constitute forward looking statements; refer to Forward Looking Statements on pages 1 to 2 of this document.

Our business model and strategy

Our 2020 vision

The bank of 2020 will be high tech and high touch, which means lower cost, high quality digital services with human expertise available when required. This will be underpinned by a clear commitment to our customers, shareholders and other stakeholders.

Our priorities

Strength and sustainability

We remain focused on building a strong and stable bank. We have continued to improve the fundamentals, by increasing our capital strength, building a robust liquidity position and balancing our loan to deposit ratio. As one of the UK's largest banks we understand the importance of supporting the UK's economic and social development.

Through our balance sheet lending and range of sustainable banking initiatives, we are working to improve outcomes for all stakeholders.

Customer experience

We are investing in our people, service, and product proposition to ensure we provide market leading technology and signature customer experiences, through a wide variety of channels.

Simplifying the bank

Streamlining of processes and removing unnecessary complexity lowers our operating costs, and makes our customer interactions more straightforward.

Supporting sustainable growth

A strong sustainable business grows with its customers. We continue to support our customers through offering products and services which meet their needs.

Employee engagement

Engaged colleagues lead to engaged customers. At RBS we are committed to investing in our colleagues and creating leaders who inspire and empower their teams.

Our Structure

We have four customer franchises, and each is underpinned by a range of distinct brands, which are the route through which we engage with our customers.

Our Brands

Our brands are our main connection with customers. Each takes a clear and differentiated position that will help us strengthen our relationships with our customers, stand out in the market, and build the value of our brands.

Our business model and strategy

Building a more sustainable bank

Our long term success is dependent on our ability to generate value for society by providing products, services and facilities that are useful to people and the communities in which we operate. Our value creation model is a simplified way of showing how this works, including the way we use resources, skills and relationships to deliver value for all our stakeholders.

One of the ways by which we meet the expectations of our shareholders is by delivering the best possible service for customers to meet their needs. At the same time, we recognise our responsibility towards society as a whole. It is only by supporting our customers and communities to succeed that we will be become a more sustainable bank.

Our key resources and relationships

RBS provides financial services to individuals and businesses, primarily in the UK and Ireland. We rely on financial, human and intellectual, social and relationship, infrastructure and natural capital to do so. We leverage these forms of capital through our expertise, technology and customer focus across our different brands. This helps to improve the quality of customer service. We also seek to create sustainable value for our shareholders and other stakeholders, including customers, employees, and civil society.

Our approach

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Notes:

- (1) Comprises £443 million corporate tax, £504 million irrecoverable VAT, £237 million bank levies and £273 million employer payroll taxes.
- (2) Data relates to reported attempted fraud cases and prevented third party losses in the UK (not including policy declines for debit cards).
- (3) Includes people supported through the following enterprise programmes during 2017: The Prince s Trust, Skills & Opportunities Fund and Entrepreneurial Spark.
- (4) SME lending balances in over 9,854 postcode sectors across England, Scotland and Wales.
- (5) Data is compiled by Project North East (PNE) and is based on the total spend allocated by each Regional Board.

Our approach

Our Values

Our Values guide our actions every day, in every part of our business. The values are the foundation of how we work at RBS.

Our Stakeholders

RBS exists to serve customers well and we put our customers at the heart of everything we do. This means having an understanding of our impact across all stakeholders of the bank. Understanding who our stakeholders are and their views helps inform our overall strategy. Below is an overview of some of our stakeholder groups.

We have provided three examples below of how we work with different stakeholder groups:

Shareholder engagement sessions

Individual shareholder views on our plans to build a better bank are important to us.

In 2017 we hosted events in Edinburgh and London for our retail shareholders. A diverse group, selected by postcode, were invited to learn more about our business and participate in an interactive Q&A session with a panel of senior management and Board members.

These events gave those in attendance the opportunity to hear from different parts of RBS, ask questions about progress so far and learn more about our plans for the future. We set up market stalls on topics of interest including customer experience, innovation and security. They could talk with employees from different parts of the bank on progress and our plans for the future.

Additionally, we held four external stakeholder engagement sessions with our Sustainable Banking Committee on Financial Capability, UK Housing, Climate Risks and Technology Innovation for Social Good.

Working together to tackle fraud and scams

To help our customers protect themselves against fraud and scams we have been working with various partners across the industry.

NatWest sponsored the production of a Code of Practice on protecting customers from financial harm. The specification, launched in November 2017, included input from Financial Fraud Action UK, the National Trading Standards Scams Team, the Office of the Public Guardian, the Metropolitan Police, and two other major UK banks.

NatWest continue to support Friends Against Scams run by National Trading Standards and in 2017 trained over 20,000 colleagues. In 2018 we will be the official bank partner of the One Million Friends Against Scams initiative.

Closed Loop feedback

We are listening, learning and acting on our customers' feedback. We have taken customer feedback on board and acted on it. Closed loop feedback is about continuously seeking customer feedback and closing the loop on the issues that our customers raise with us.

Examples include:

It would be good if you could diarise payments . Customers can now make diarised payments via their mobile app.

Customers living abroad are unable to use the mobile app with an international number . Customers can now use our mobile app in various countries including Australia, Gibraltar, Hong Kong, New Zealand, Singapore and South Africa.

I want all audio statements to have a braille section that allows the customer to know who and what the audio tape is for and what month this relates to . All our audio statements now have a date so that customers can easily differentiate between them.

In addition, as part of our net promoter system in 2017 we sent out 11.5 million survey invites, with 875,500 responses.

Our approach

Changing face of banking

Since 2014, customers are choosing to do their banking in different ways that suit them and reflect what they do in everyday life. The number of customers using our branches across the UK has fallen by 40% and during the same period mobile banking transactions increased by 73%; in the first half of 2017, there were 1.1 billion mobile and online transactions carried out by our customers.

We are committed to ensuring that our customers have a wide range of ways in which they can bank with us. Every customer is individual and that is why customers can choose from a combination of digital, telephone and face-to-face banking options, each designed to suit their preferences and needs. Customers might carry out simple everyday transactions using our mobile app but still preferring to speak to someone over the phone or via webchat for other banking queries. For more complex needs, such as a Financial Health Check or mortgage advice, customers value having the option to discuss the matter face-to-face or by video.

We are working hard to develop new services to respond to the changing needs and expectations of our customers. All our personal customers can bank with us using our mobile app and online banking services and we have Bankline for business and commercial customers. We also provide a 24/7 webchat service for personal customers, telephony and secure text messaging for when customers want to contact us quickly, digitally and securely.

Closing branches is always a difficult decision and one we do not take lightly. When these decisions are made, we look at each branch and take into account a range of factors including, how customers are choosing to bank with us; how often customers are using the branch; the impact on customers who currently use the branch; other options available to customers including online, mobile, telephony, webchat, cash machines, video banking and local Post Offices and, the proximity of our other branches, including our network of mobile branches and local transport routes and timetables.

We know that for some customers, in particular vulnerable customers, closing branches can be unsettling. We are committed to ensuring that we support all customers with these changes. We aim to provide six months notice before we close a branch (the industry norm is 12 weeks) and we proactively contact our regular branch users and vulnerable customers to talk to them about our decision and the options available to them.

Our national contract with the Post Office means that customers can undertake everyday banking in any of the 11,500 Post Offices throughout the UK. In many areas, we operate mobile branches, which bring our banking services direct to local communities, many of which have not had a branch before.

We acknowledge that some of our customers are not comfortable with using online or mobile banking, and for those customers who would value some support we have created a specialist taskforce of TechXperts who are dedicated to supporting our customers with training and support with digital skills. Our TechXperts support customers with the varied ways to bank and for example accompany customers to the local Post Office to show them how their banking can be done.

We have introduced a number of roles to provide personal, face-to-face banking services in communities, assisting customers with access to our non-cash services, offering support with financial planning and education. Our Community Bankers base themselves in places like libraries, local businesses and community centres so as to best serve local communities. Business Growth Enablers focus on our small business customers. They are specially trained to help source advice that will help local businesses with banking support, as well as harnessing their own network to support business needs. Business Growth Enablers work with industry partners to run free events for customers on issues such as fraud, scams and digital tax returns.

Climate change

We recognise climate change is a significant global issue and we fully support the objectives of the Paris Climate Agreement and the emissions reductions strategies set by the UK and devolved governments. We have publicly pledged our support for the Financial Stability Board's (FSB) Taskforce on Climate-related Financial Disclosures (TCFD) and we have included more detail on our approach to the TCFD recommendations in the Additional Information section of the 2017 Annual Report on Form 20-F. We also plan to announce further details of our long term approach to climate change.

We believe there is a need to support our customers to reduce their emissions, save energy and manage their costs. Over the last decade, we have become one of the leading lenders to the UK Sustainable Energy market, with expertise and services designed for customers from small businesses up to large corporations. RBS was recognised by InfraDeals as the leading lender to the UK renewables sector by number of transactions over the past six years (2012- 2017).

As we have refocused our business on the UK, Ireland and Western Europe, we've also substantially reduced our lending to carbon intensive parts of the global economy such as coal mining and oil extraction. Our total exposure to the oil and gas industry, for example, now accounts for just 0.5% of our lending exposures. In 2017 we did not directly finance any new coal mining or coal power projects. More details of our lending to the energy sector will be published on our Sustainable Banking webpages on rbs.com in April 2018.

Relative to our size, our operational footprint from serving our customers is quite small, but still significant. Our primary emissions impact comes from the energy used to heat, cool and power our buildings and data centres. We have set targets using a science-based method in order to align our efforts to reduce emissions with the climate science that sits behind the Paris Climate Agreement. Our target for 2020 is to reduce our direct carbon emissions by 45% from a 2014 baseline and at the end of 2017 we had already recorded a 39% reduction. The table below provides more detail.

We have also set 2020 targets to reduce water use by 10% and paper use by 60%, whilst continuing to target zero waste to landfill. We engage colleagues, suppliers and customers in these efforts and in 2017, 3,200 colleagues logged over 24,000 activities to reduce our environmental impact via our green reward app. More information on our targets and initiatives can be found on the Sustainable Banking webpages at rbs.com.

	2014 (Baseline)	2016	2017	Change 2014 to 2017 (%)
GHG Emissions				

Location-based CO2e emissions (Scope 1, 2 and Business Travel) (tonnes)	512,583	388,648	311,583	-39%
Scope 1* CO2e emissions (tonnes)	36,857	29,131	27,172	-26%
Scope 2** Market-based*** CO2e emissions (tonnes)	391,105	159,629	76,197	-81%
Scope 2 Location-based CO2e emissions (tonnes)	370,374	270,481	215,959	-42%
Scope 1 and 2 Location-based CO2e emissions per FTE (tonnes)	4.16	3.32	3.18	-24%
Scope 3**** CO2e emissions from business travel (tonnes)	105,352	89,036	68,452	-35%

We have reported on all emission sources under the Companies Act 2006 (Strategic Report and Directors' Reports) Regulations 2013. To our knowledge there are no material omissions. Independent Limited assurance has been provided by Ernst & Young LLP over total reported CO2e emissions (tonnes) (Scope 1*,2** and 3*** location based emissions). Our reporting year runs from October 2016 to September 2017.

These emissions have been calculated using the methodology advised in the Greenhouse Gas Protocol revised edition (2004). The boundary of reporting is set as all entities and facilities either owned or under operational control. Emissions factors used are from UK Government's GHG Conversion factors (DEFRA), IEA, or relevant local authorities.

*Scope 1: Emissions from fluorinated gas loss and fuel combustion in RBS premises/vehicles. **Scope 2: Emissions from electricity, district heating and district cooling used in RBS premises. *** market-based emissions have been calculated using the GHG Protocol guidelines. ****Scope 3: Emissions associated with business travel (air, rail and road) by RBS employees.

Human rights and Modern Slavery Act

RBS takes a proactive approach to upholding our commitment to respect human rights and our approach is centred on identifying and mitigating potential human rights risks across our business and our wider sphere of influence. The Modern Slavery Act 2015 (MSA) forms part of our approach to human rights as this regulation brings together the serious criminal offences of slavery, servitude, forced or compulsory labour and human trafficking together under one piece of legislation. In 2017 we published our first annual statement on the MSA on rbs.com. This built upon our interim statement which was published in December 2016 and our existing policy framework.

Our approach is underpinned by Our Values and Our Standards. For employees this is via the RBS Code of Conduct Our Code . Our Code includes a clear commitment to respect human rights, supported by the Yes Check, a tool to guide good decision making. Employees are consulted on key aspects of their working environment, and they can utilise a confidential helpline to discuss any matters of concern.

Our commitment to the international progress of human rights includes upholding the principles of the United Nations Global Compact since 2003.

We are committed to the implementation of the United Nations Guiding Principles on Business and Human Rights and participate with our peers in groups such as the Thun Group and United Nations Environment Programme Finance Initiative. We have been adopters of the Equator Principles since their inception in 2003 to manage social and environmental risks, including human rights, in project- related transactions.

We have sector-specific Environmental, Social and Ethical (ESE) risk policies (available at rbs.com/sustainable) which include human rights considerations for high-risk sectors. For customers outside these sectors, our general ESE risk concerns policy ensures due diligence is carried out on clients when human rights risks are identified. We expect our customers to share our commitment to respecting human rights within their operations.

Our Customers

We are aware that as a High Street bank we come into contact with millions of customers, some of whom may be victims of modern slavery. Our relationship with our customers is governed by a wide range of risk considerations, including our Anti-Money Laundering (AML) and Environmental, Social, and Ethical (ESE) risk assessments on current or new customers, to consider whether any of their activities carry human rights infringements.

Our People

All of our people are recruited legally and must meet the 1998 Immigration Act requirements.

RBS is a fully accredited Living Wage Employer. We gained accreditation in 2014. RBS' commitment as a Living Wage accredited employer applies to everyone working for the bank in the UK and has been extended to staff who are employed via suppliers (e.g. cleaning, security and catering staff). Employees are regularly consulted on their working conditions and a confidential helpline is available at all times.

Our Suppliers

We expect our suppliers to uphold the same values and commitments that we have made in relation to social and environmental impacts. Adherence to these policies is required as part of our supply chain tendering process and within our supplier contracts.

Our Sustainable Procurement Code sets out the international human rights commitments we expect of the companies that we work with, including labour standards and non-discrimination.

Our approach

Our Colleagues

Engaging our colleagues is critical to delivering on our strategy and ambition as a bank. Being better for our colleagues means we are better for our customers, and this makes us a better bank.

Creating a Healthy Culture

Building a healthy culture that embodies Our Values is one of our core priorities. Our Values guide the way we identify the right people to serve our customers well, and how we manage, engage and reward our colleagues.

Our Values are at the heart of both Our Standards, the bank-wide behavioural framework and Our Code, the bank-wide Code of Conduct.

Our values are integral to the way we behave and do business and we continue to reinforce them in our systems, policies and processes, communications training and leadership role modelling.

We set ourselves clear cultural priorities each year and manage these through our Executive Committee.

We monitor our progress against our goals. We gather feedback from our colleagues through our listening strategy, and through metrics and key performance indicators to assess our progress and respond accordingly. We do this along with feedback from regulators and industry bodies.

Almost 60,000 colleagues completed our most recent colleague opinion survey. The results were the most positive we've seen in recent times and showed we're changing the culture of the bank for the better. Key measures of engagement, leadership and our culture have improved significantly, and we're now above the global financial services norm in the majority of our survey categories. The results are encouraging, and show that our hard work is paying off. However, we recognise that we have more to do to make this a stronger bank and a great place to work.

We encourage colleagues to tell us what they think via the annual colleague survey and our regular comments boards. When colleagues wish to report concerns relating to wrong doing or misconduct they can raise concerns via Speak Up, the bank's whistleblowing service. In 2017 289 cases were raised compared to 213 in 2016.

Performance and Reward

Our approach to performance management provides clarity for our colleagues about how their contribution links to our ambition and all our colleagues have goals set across a balanced scorecard of measures.

Further progress has been made in making sure employees are paid fairly for the work they do and are supported by simple and transparent pay structures. More employees have moved to a purely fixed pay construct during the year, allowing them to concentrate on providing excellent customer service. We will continue to make further changes in 2018 which will result in over half of our employees being on a purely fixed pay construct making their pay fairer and easier to understand.

We are confident that we pay our employees fairly. We keep our HR policies and processes under review to ensure we do so.

Our rates of pay continue to exceed the Living Wage and changes have been introduced to ensure people performing the same roles are paid more consistently.

More information on our remuneration policies can be found in the 2017 Annual Report on Form 20-F.

Learning

Determined to lead (DtI), our core leadership programme is now embedded as business as usualDtI provides consistent tools to lead and engage our colleagues and is transforming the way we operate. In 2017 a further 3,000 leaders participated in the programme.

2017 saw over 16,000 colleagues undertake stage one of Service Excellence training, our customer service programme. This first module introduces our Core Service Behaviours and provides an awareness of the tools and techniques that will help us to deliver the best possible service, every time.

We continue to work closely with the Chartered Banker Institute and Chartered Banker Professional Standards Board (CB:PSB) to professionalise our colleagues. In 2017 we again achieved an Excel rating in the CB:PSB Foundation Standard review, and remain one of only two CB:PSB member firms to have secured Earned Autonomy.

We also offer a wide range of additional learning opportunities.

Health and Wellbeing

Wellbeing is a strong pillar in making the bank a great place to work. In 2017 our wellbeing programme successfully delivered against three wellbeing pillars; Physical, Mental, Social and we have started to put in place support against our fourth area of Financial Wellbeing. For the third year running we participated in the Global Challenge (formerly GCC) and with 34,000 colleagues taking part we won the Global Challenge 1st Most Active Organisation Financial Industry. Building on this success, we embraced the rapid acceleration of digital wellbeing and are one of the few large organisations to pilot a digital wellbeing platform.

During 2017 we have continued to support Time to Change (removing the stigma of mental health) and actively encouraged open dialogue across the bank to support Mental Health in the Workplace. We were successful in running bankwide major online campaigns to support Mental Health Awareness Week and World Mental Health Day.

As we continue to support our colleagues through change we have fully utilised the services of our Employee Assistance Programme.

Inclusion

Building a more inclusive RBS is essential for our customers and colleagues.

Our inclusion policy applies to all our colleagues globally to make sure everyone feels included and valued, regardless of their background.

- As at 31 December 2017, our permanent headcount was 71,924. 49% were male and 51% female.
- We continue to work towards our target of having at least 30% senior women in our top three leadership layers across each Function and Franchise by 2020. As at the 31 December 2017 we have, on aggregate, 37% women in our top three leadership layers, and our pipeline (around 5000 of our most senior roles) has 44% women. We are on track to have a fully balanced workforce at all levels of the organisation by 2030.
- RBS plc's gender pay gap in Great Britain is 37.2% (median 36.5%). The figures also show a gender bonus gap of 64.4% (median 36.6%).

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- A key driver behind the gap is the fact that we have more men in senior roles (which attract higher pay) than women. In order to close the gender pay gap, we must continue to improve our gender balance in our most senior roles, and here we are making good progress. We have a positive action approach in place, tailored by business, according to the specific challenges they face. As we continue to increase the proportion of women working in senior roles, we expect our gender pay gap will lessen.
- During 2017, we continued to roll out unconscious bias learning to all our colleagues to create a solid platform for the wider inclusion agenda. 70% of colleagues have now participated in unconscious bias training since it was introduced in 2015.
- We have plans in place for all segments of our pan-bank disability plan. It addresses areas for improvement including branch access, accessible services, improving colleague adjustment processes and inserting disability checkpoints into our key processes and practices.
- We continue to focus on building an ethnically diverse RBS. Our plan focuses on positive action and includes reciprocal mentoring, targeted development workshops and leadership programmes and ensuring we have a Black, Asian and Minority Ethnic (BAME) focus on recruitment, talent identification and promotion. We will introduce explicit targets for BAME representation at senior levels in 2018.
- Our LGBT agenda continues to deliver a better experience for our LGBT colleagues and customers. We have processes in place to support updating gender and title on customers banking records and to support colleagues undergoing gender transition. And, we continue to support our c.20,000-strong colleague networks.

Grade	#Women	#Men	%Women
CEO 1	5	9	36
CEO 2	35	66	35
CEO 3	232	397	37
CEO 4	1,309	1,681	44
Target population (CEO 3 and above)	272	472	37
		Male	Female
Executive Employees		90 (76%)	28 (24%)
Directors of Subsidiaries		184 (80%)	45 (20%)

There were 347 senior managers (in accordance with the definition contained within the relevant Companies Act legislation), which comprises our executive population and individuals who are directors of our subsidiaries. The RBS Board of directors has fourteen members, consisting of nine male and five female directors.

Our Customers

RBS remains committed to achieving its target of being the number one bank for customer service, trust and advocacy by 2020.

Customer

In 2017 we made it our goal to significantly increase NPS or maintain number one in our chosen customer segments. This strategy was implemented to support the overall aim of being the number one bank for customer service, trust and advocacy by 2020.

We use independent surveys to track the progress we are making to achieve our goals in each of our markets and to also measure our customers experience.

To measure advocacy, customers are asked how likely they would be to recommend their bank to a friend or colleague, and respond based on a 0-10 scale with 10 indicating extremely likely and 0 indicating not at all likely. Customers scoring 0 to 6 are termed detractors and customers scoring 9 to 10 are termed promoters. The net-promoter score (NPS) is established by subtracting the proportion of detractors from the proportion of promoters.

We also use independent experts to measure our customers trust in the bank. Each quarter we ask customers to what extent they trust or distrust their bank to do the right thing. The score is a net measure of those customers that trust their bank (a lot or somewhat) minus those that distrust their bank (a lot or somewhat).

Our Commercial Banking NPS has remained stable during 2017 and remains ahead of its main competitors. In England & Wales, NPS for NatWest Personal Banking has also remained stable and we have met our target for customer trust. In Scotland, while we have not met our target for customer trust for Royal Bank of Scotland, it has increased strongly year on year. We do recognise that significant work is required to improve our customer experience and we continue our work to resolve the ongoing reputational and legacy issues.

	Q4 2016	Q3 2017	Q4 2017
NatWest (England & Wales) (1)	13	12	12
Royal Bank of Scotland (Scotland) (1)	(4)	(13)	(6)
NPS: Personal Banking			

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	Ulster Bank (Northern Ireland) (2)	(16)	(4)	(5)
	Ulster Bank (Republic of Ireland) (2)	(7)	(6)	(7)
	NatWest (England & Wales) (3)	(2)	(10)	(7)
NPS: Business Banking	Royal Bank of Scotland (Scotland) (3)	(5)	(14)	(15)
NPS: Commercial Banking (4)	NatWest (England & Wales)	20 55%	21 59%	21 57%
Trust(5)	Royal Bank of Scotland (Scotland)	13%	22%	27%

Notes:

(1) Source: GfK FRS 6 month rolling data. Latest base sizes: NatWest (England & Wales) (3361) Royal Bank of Scotland (Scotland) (440). Based on the question: How likely is it that you would recommend (brand) to a relative, friend or colleague in the next 12 months for current account banking? Base: Claimed main banked current account customers.

(2) Source: Coyne Research 12 month rolling data. Latest base sizes: Ulster Bank NI (294) Ulster Bank RoI (275) Question: Please indicate to what extent you would be likely to recommend (brand) to your friends or family using a scale of 0 to 10 where 0 is not at all likely and 10 is extremely likely .

(3) Source: Charterhouse Research Business Banking Survey, YE Q4 2017. Based on interviews with businesses with an annual turnover up to £2 million. Latest base sizes: NatWest England & Wales (1245), RBS Scotland (437). Question: How likely would you be to recommend (bank) . Base: Claimed main bank. Data weighted by region and turnover to be representative of businesses in Great Britain.

(4) Source: Charterhouse Research Business Banking Survey, YE Q4 2017. Commercial £2m+ in GB (RBSG sample size, excluding don't knows: (904). Question: How likely would you be to recommend (bank) . Base: Claimed main bank. Data weighted by region and turnover to be representative of businesses in Great Britain.

(5) Source: Populus. Latest quarter's data. Measured as a net of those that trust RBS/NatWest to do the right thing, less those that do not. Latest base sizes: NatWest, England & Wales (948), RBS Scotland (203).

Our operating environment

Key influences in our operating environment

Our ability to serve customers and create value for the long term is heavily influenced by the environment in which we operate. Every year we assess the importance of these influences both in terms of their relevance to our stakeholders (including customers, investors, UK government, employees and civil society) and their potential commercial impact on us.

An assessment of the most important influences in our operating environment are detailed below. The influences have been identified through various means, including, internal and external stakeholder engagement and review of internal and external sources. These considerations have the potential to influence our ability to serve customers and create value for the long term. They carry both risks and opportunities, driven by a mixture of direct commercial impact and stakeholder interest as a result of wider societal trends.

In the following pages, each influence is briefly described together with selected highlights in 2017 and with guidance on where you can find more information on that key influence.

Our operating environment

Influences explained and where to find out more.

Find out more

Chairman and CEO review 2017 Performance Summary Business model and strategy Our Stakeholders Our Colleagues Our Customers Key economic overview indicators Risk Sustainable Banking report

Key Influences	Definition	Selected highlights in 2017	Where to find out more	
Critical considerations that support our ambition to be No.1 for customer service, trust and advocacy				
Customer service	Delivering excellent customer service is essential for the banking sector to build trust. Maintaining and growing a loyal and satisfied customer base requires an appropriate digital and physical presence and clear distribution strategy.	<ul style="list-style-type: none"> Approximately 5.5 million active users regularly benefit from the speed and convenience of our mobile banking app with +51 net promoter score. Closed Loop Feedback provides us real-time feedback from our customers which we are listening to, learning from and acting on every day. Rolled out a Service Excellence programme, to further improve our customer service. 		
Employee wellbeing & engagement	Employee engagement and satisfaction is highly correlated with overall performance. A key determinant of the bank's success will be ensuring all of its employees are clear on their roles and responsibilities, capable and feel motivated to do the best job possible.	<ul style="list-style-type: none"> Our View, the bank's annual employee feedback survey showed that engagement is up by seven percentage points to 83% compared with 2016, the highest level since 2002. Launched 'Building a great place to work' to support our commitment to giving our employees a fulfilling career, fair pay, relevant training and good leadership. Actively supported Mental Health Awareness Week, enabling employees to speak more openly about mental health and support each other. 		

<p>Ethics, culture and integrity</p>	<p>Professional integrity is a key governance consideration in the banking sector. Services provided must satisfy the highest professional standards, avoid conflicts of interest, bias, or negligence, and ensure that all stakeholders, including employees, contractors and business partners, are treated fairly and equally.</p>	<ul style="list-style-type: none"> Improved our position in the latest Banking Standards Board (BSB) survey, which seeks to promote high standards of behaviour and competence across the UK banking industry. RBS improved in all nine BSB survey categories compared with 2016 results and in quartile performance against its peer group. Employed the greatest number of UK employees with professional banking qualifications. RBS employs more bankers with a professional banking qualification from the Chartered Banker Institute than any other UK financial institution. Members are required to comply with the annual CPD requirements of the professional body. The Chartered Banker Institute is the UK's only and world's oldest professional body for banking. Speak Up, our whistleblowing service, received 289 reports compared to 213 reports in 2016. The service allows employees to raise concerns in a safe and supportive environment so that potential issues can be addressed quickly and effectively. 		
<p>Operational competence</p>	<p>Delivering appropriate digital infrastructure is important to ensure a technically-able bank that supports its long-term future. Cyber security is also a vital part of providing a safe and secure banking service. Banks need to proactively identify and manage risks and efficiencies in their operations and facilities.</p>	<ul style="list-style-type: none"> RBS is a founding partner of Friends Against Scams, the National Trading Standards Scams Team's fraud and scams awareness initiative. More than 20,000 colleagues have completed the relevant training. Improved the in-branch digital experience with TechXperts in every branch to advise and support customers on how to have a secure online banking experience. The in-branch wi-fi capability has also been improved. There has been a sustained improvement in the number of customers impacted by fraud with a 26% reduction compared with 2016. Resilient, simple and efficient systems are critical to building the number one bank for customer service, trust and advocacy. Our systems are available 99.9% of the time. 		
<p>Strength and stability</p>	<p>Banks need to demonstrate their ability to survive financial stress arising from economic turmoil, and potential large scale fines and legal cases resulting from historic events. They must also demonstrate they have sufficient capital, liquidity and resilience as well as the ability to generate sufficient returns.</p>	<ul style="list-style-type: none"> The CET1 ratio increased by 250 basis points to 15.9% in 2017 despite absorbing significant additional legacy costs. RWAs reduced by £27 billion (12%), ending the year at £201 billion (from £228 billion in 2016). This reduction was driven by NatWest Markets, where RWAs fell by £16.8 billion due to the continued run-off of the legacy business and mitigation activities in the core business, together with active management of the lending book in Commercial Banking. 		

		<ul style="list-style-type: none">• A key milestone in our ring-fencing journey was achieved through the application to the Court of Session in Edinburgh to initiate a Ring-Fencing Transfer Scheme so as to carry out a legal transfer of some of our business.		
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Key Influences	Definition	Selected highlights in 2017	Where to find out more	
Current Priority Considerations				
Banking regulation	Banks continue to operate in an environment where regulatory change is frequent and increasingly complex requiring significant time and resources.	<ul style="list-style-type: none"> • RBS continues to deliver on its plan to build a strong, simple and fair bank for both customers and shareholders. To support this, and in preparation for the UK ring-fencing regime, the previously reported operating segments were realigned in Q4 2017 and a number of business transfers completed. Refer to the Report of the directors for further details. • NatWest Markets aligned the majority of Functions and Services employees in 2017 in preparation for operating as a non-ring-fenced bank. • RBS Group published a Tax Strategy. • Regulatory changes that RBS worked on in 2017 included MiFID II / MiFIR, Open Banking and reform of capital and liquidity regulations. 		
Conduct	Banks remain focused on putting in place measures to prevent issues related to conduct. At the same time, legacy conduct issues, such as RMBS, continue to have major financial and reputational impacts.	<ul style="list-style-type: none"> • A settlement with the Federal Housing Finance Agency (FHFA) and the California State Attorney General in the US was reached. • The 2008 rights issue shareholder litigation was resolved. 		
Competition and Innovation	The banking sector is going through a period of rapid change with regulatory and technological trends converging to increase competition. Together with accelerating innovation, the UK implementation of the Open Banking Standards raises the potential for significant disruption of the traditional banking business model.	<ul style="list-style-type: none"> • Partnered with FreeAgent, an Edinburgh-based Fintech that provides online accounting software, to help our small business customers track their finances and report their taxes digitally. • Introduced a chat bot called Cora that answers questions from customers 24/7, freeing up colleagues time so that they can help customers with more complex queries. Cora currently handles over 100,000 customer conversations per month across our web and online channels. • Plans are in place for Open Banking, including customer education around security awareness. 		

<p>Diversity, equality & inclusion</p>	<p>The inclusion agenda is quickly moving up the corporate agenda and driving the need to foster corporate cultures that value diversity, teamwork, quality leadership and training.</p>	<ul style="list-style-type: none"> • Made progress against our 2020 targets on our four priorities: Lesbian, Gay, Bisexual, Transgender (LGBT), Gender Balanced, Disability Smart, Ethnically Diverse. • Supported the International Day of Persons with Disability sharing stories across the bank and with customers. • Recorded an increase in the total number of female leaders within our top three senior layers, including the appointment of two new female non-executive board directors. • RBS was named a Times Top 50 employer for Women and rated as a Stonewall Top Global Employer. 		
<p>Health of the UK and global economy</p>	<p>The outlook for the UK and global economy remains uncertain due to a number of factors including: the UK's vote to leave in the EU referendum, wider political instability, an extended period of low interest rates, high debt levels and delays in normalising monetary policy.</p>	<ul style="list-style-type: none"> • The UK economy grew by 1.8% in 2017, down slightly from 1.9% in 2016, below the long-run average of more than 2%. • The main development in 2017 was higher inflation. Along with weak wage growth it meant that households' incomes were squeezed. • The eurozone economy was 2.7% larger in the final quarter of 2017 than in the same period of 2016, up from 1.8% in 2016. Unemployment fell but remained high at 8.7%. • US growth accelerated to 2.3%. The job market remained buoyant with 1.8 million jobs added during the year and the unemployment rate falling to 4.1%. 		
<p>Political landscape</p>	<p>Political risks continue to evolve with the UK's vote to leave in the EU referendum creating significant economic, political and regulatory uncertainty. Heightened geopolitical tensions and rising populism in advanced economies have also contributed towards a rise in uncertainty.</p>	<ul style="list-style-type: none"> • In 2017 NatWest Markets announced its plan to repurpose the existing licence in the Netherlands in the event of loss of EU passporting as a result of the UK's departure from the EU. • We engage the UK Government and opposition political parties to understand their priorities for the sector. 		

Our operating environment

Key Influences	Definition	Selected highlights in 2017	Where to find out more	
<p>Privacy</p>	<p>As a bank our customers not only trust us with their finances but also with their information. It is therefore important that we deal with their information the right way. By doing the right thing in meeting the privacy expectations of our employees, customers and shareholders we build confidence, which in turn builds trust and therefore has a tangible influence on delivering the bank's ambition to be No.1 for customer service, trust and advocacy.</p>	<ul style="list-style-type: none"> • The bank takes privacy and the protection of customers and employee data very seriously, and has worked with other banks to make sure it is factored into the Open Baking architecture. • The new General Data Protection Regulation (GDPR) comes into effect on 25 May 2018 and brings a new era in safeguarding personal data by businesses. • The bank has been preparing for GDPR since April 2016. • The GDPR grants new and enhanced rights for individuals in relation to their personal information and, as 25 May approaches, the bank will communicate more fully with customers and clients about these changes and how they can exercise their rights. 		
<p>Skills and capability of staff</p>	<p>Financial services companies face competition for skilled employees, in particular with specific skillsets (e.g. IT). As the industry transforms to more digital banking, the need for such skills may become more acute.</p>	<ul style="list-style-type: none"> • Delivered the Entrepreneurial Development Academy, a programme designed in partnership with E-Spark, specifically for RBS employees to develop an entrepreneurial mindset. Over 5,900 employees participated in the programme. • Over 64,600 employees underwent training by the Chartered Banker Professional Standards Board (CB:PSB) with 94% of applicable staff achieving the CB:PSB Foundation Standard. • Introduced a new tool to help our people learn and develop for example career development days and mobile learning. • RBS was recognised as a Top 5 Apprentice UK Employer. 		

Support for enterprise	A healthy economy needs a pipeline of new and growing businesses to spur innovation and growth. Entrepreneurs, start-ups and small businesses require particular support in terms of financing and building market share.	<ul style="list-style-type: none"> • Rolled out ESME, a digital platform which offers SMEs the ability to digitally obtain loans quickly, potentially within an hour, on a 24/7 basis. • Launched Pitch App to help entrepreneurs communicate with impact. • Entrepreneurial Spark opened an accelerator hub in London, our 12 accelerators are now in every region of the UK. 		
Trust in the banking sector	Trust in traditional large UK banks often lags behind smaller competitors and new market entrants. Rebuilding trust remains a key challenge.	<ul style="list-style-type: none"> • Customer trust in NatWest in England & Wales has met its 2017 target of 57%, improving from 55% at Q4 2016 to 57% at Q4 2017. • Trust in RBS in Scotland has increased strongly year on year (from 13% in Q4 2016 to 27% in Q4 2017) but remains behind its target of 38% for 2017. • Our Board Sustainable Banking Committee hosted stakeholder engagement sessions and two retail shareholder events. 		
Housing	Demand for housing in some parts of the UK and Republic of Ireland outstrips supply, reducing affordability and harming family disposable incomes.	<ul style="list-style-type: none"> • Board Sustainable Banking Committee held a stakeholder engagement session on housing, inviting a variety of external stakeholder groups to share their perspectives with us. • Your Mortgage Awards 2016 - 2017: Best First-Time Buyer Mortgage Lender, Best Bank. • What Mortgage Awards 2017: Best National Bank, Best Lender Customer Service. • Gross new mortgage lending of £33.9 billion in UK PBB, Ulster Bank Rol, Private Banking and RBSI. 		
Long term and emerging considerations				
Changing customer needs	Customer needs are changing and different types of customer often have significantly different banking needs. In order to be attractive and useful, financial products and services need to fit in with customers' lives and be flexible to differing levels of digital and financial understanding.	<ul style="list-style-type: none"> • 68% of our personal customers are active across our mobile and online banking platforms. • Launched Strategic Account Opening meaning our personal customers can open an account in five minutes. • Launched the UK's first ever paperless mortgage - customers can now apply for a completely digital 		

		<p>mortgage which uses the latest technology to securely share and verify documents online.</p> <ul style="list-style-type: none">• Our Home Insurance Quote and Buy system gives customers cover in less than fifteen minutes.• One of the first large UK banks to launch robo-investment advice service through NatWest Invest.		
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Key Influences	Definition	Selected highlights in 2017	Where to find out more	
Climate change	<p>The Paris Agreement provides a framework by which the world will seek to prevent dangerous climate change but further challenges remain. Climate change presents both physical and transition risks. The transition to a low carbon economy is also presenting opportunities for low carbon sectors of the economy. There are also increasing regulatory and stakeholder expectations of banks to address climate change.</p>	<ul style="list-style-type: none"> RBS has pledged its support to the Task Force on Climate-related Financial Disclosures (TCFD). Board Sustainable Banking Committee held a stakeholder engagement session on Climate risk, inviting a variety of external stakeholders groups to share their perspectives with us. We have been recognised by InfraDeals as the leading lender to the UK renewables sector by number of transactions over the past six years (2012- 2017). Set a new carbon reduction target using a science-based method, aligning our ambition with the Paris Climate Agreement. 		
Executive pay	<p>Shareholders, employees and the general public have shown increasing concerns about the inequality in pay in large companies between senior executives and the general workforce.</p>	<ul style="list-style-type: none"> Bonus pools have fallen by around 75% since 2010, aligned with the restructuring that has taken place and the actions taken by Group Performance and Remuneration Committee. Remuneration is allocated over a multi year basis, with the ability to apply malus and clawback to encourage good behaviours and a long-term focus. Introduction of a new policy for Executive Directors in 2017, with significantly lower maximum award levels and with increased shareholding requirements. 		
Financial capability	<p>A customer's ability to manage money well, both day to day and through significant life events, and their ability to handle periods of financial difficulty. It focuses on developing financial skills and knowledge, attitudes, and motivation, which can help customers avoid falling into financial difficulty and can improve their financial health and well being.</p>	<ul style="list-style-type: none"> MoneySense, our financial education programme for 5 to 18 year olds, won Digital Information Product of the Year (PPA Digital Awards) in recognition of how it has adapted to the digital age with engaging and interactive content to support teachers and parents. Completed over one million Financial Health Checks in 2017. 		
Social inequality & financial exclusion	<p>The increasing gap between rich and poor and the rising cost of living means many UK consumers find themselves in precarious financial situations and are struggling to manage their money day to day. This, with future economic uncertainty, may well lead to increased bad debt and over indebtedness. In addition millions do not have access to mainstream financial services such as free ATMs, credit, and banking products together with lack of digital footprint and skills and are forced to rely on</p>	<ul style="list-style-type: none"> Helped over 680,000 customers in financial hardship find a solution to their debt problem. Provided over 27,500 customers with breathing space and extra time for them to find support and to put in place a repayment arrangement. Innovative Citizens Advice partnership, where Citizens Advice colleagues are located within one of our Specialist Support teams providing independent advice to over 900 of our most vulnerable customers. 		

	high-cost products.	<ul style="list-style-type: none"> In partnership with the Money Advice Trust, we developed industry leading Addictions Training for our colleagues and use across the sector. 		
UK infrastructure	The UK has a significant need for new infrastructure, such as energy, transport and project finance. Banks have an important role in supporting infrastructure investment across the UK.	<ul style="list-style-type: none"> Banks like RBS have a key role supporting this investment, through lending and sourcing global capital markets financing. 		

Independent assurance

The Royal Bank of Scotland Group plc appointed Ernst & Young LLP to provide limited independent assurance over selected sustainability content within the Strategic Report (the Report), as at and for the period ended 31 December 2017. The assurance engagement was planned and performed in accordance with the International Standard for Assurance Engagements (ISAE) 3000 Revised, Assurance Engagements Other Than Audits or Reviews of Historical Financial Information.

These procedures were designed to conclude on:

- The consistency of selected narrative claims on sustainability with underlying performance information, and;
- The accuracy and completeness of the sustainability performance indicators listed below:
 - Value (£) of attempted fraud prevented in the UK
 - Total gender balance in top 3 senior layers
 - Total number of people supported through enterprise programmes
 - % personal customers who are digitally active
 - Total number of Financial Health Checks
 - Banking Standards Board survey results
 - % of staff who received CB:PSB standards certification
 - Total scope 1 and 2 location based CO2e emissions Scope 3 emissions from business travel.

An unqualified opinion was issued and is available on rbs.com, along with further details of the scope, respective responsibilities, work performed, limitations and conclusions.

Our operating environment

Key economic indicators

The UK economy grew by 1.8% in 2017, down slightly from 1.9% in 2016. That was below the long-run average of more than 2%.

In a healthy job market, the number of people in work increased by around 400,000 and unemployment fell to 4.3%, the lowest rate since 1975. As a result of the 17% fall in the value of sterling that began in 2015, inflation accelerated, peaking at 3.1%. Higher inflation was one reason the Monetary Policy Committee (MPC) voted to increase Bank Rate to 0.5% in November. With wage growth of around 2.5%, households' spending power was squeezed. Business profitability remained strong and business investment grew by 1.7% in the year to the third quarter. House price inflation remained around 5%.

Summary

The main development in 2017 was higher inflation. Along with weak wage growth it meant that households' incomes were squeezed. As a result, household spending grew by 1.0% in the year to the third quarter and retail sales volumes increased by 1.4% in the year to December. While some households curbed their spending others ran down their savings – the saving ratio reached a record low of 4.0% in the first quarter – and consumer credit grew by 9.5% in the twelve months to December. Employment continued to rise strongly but wage growth remained modest for most of the year, meaning domestically-generated inflationary pressures were muted. However, the MPC judged that the pace of growth – including the still-improving labour market – combined believed that Bank Rate would be at or close to 0.75% in December 2018.

The Republic of Ireland appears to have grown strongly. Unemployment continued to fall, ending the year at 6.2%, its lowest rate since 2008. Consumer price inflation remained subdued at 0.4%. House price inflation accelerated to around 12% from 9.0% in 2016. This returned prices to their 2009 level and still almost one-quarter below the peak in nominal terms.

The eurozone economy was 2.7% larger in the final quarter of 2017 than in the same period of 2016, up from 1.8% in 2016. Unemployment fell but remained high at 8.7%. While inflation increased to 1.4% it remained short of the European Central Bank's target of at or below 2%. The ECB continued to provide stimulus through low interest rates and quantitative easing. It announced in October that it would reduce the amount of its monthly asset purchases while extending the period during which it will make purchases until at least September 2018.

US growth accelerated to 2.3%. The job market remained buoyant with 1.8 million jobs added during the year and the unemployment rate falling to 4.1%. However, wage growth remained modest and consumer price inflation was well below the Fed's 2% target. However, the central bank continued to tighten policy with three rate rises during the year, taking the Fed Funds with what it judges to be a slower rate of potential expansion would have resulted in higher than acceptable inflation had it not raised Bank Rate. In indicating that Bank Rate would rise further, the Committee

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emphasised that subsequent increases would be gradual and limited. At the year s end, markets Target Rate to 1.25% - 1.50%.

In China, growth was broadly stable at 6.9%. This was in part a consequence of continued stimulus, which resulted in a further rise in indebtedness. Recognising this, the authorities took steps to limit the growth of credit.

Our operating environment

Risk overview

Effective risk management is at the heart of the successful development and execution of the RBS strategy

An emphasis on strong risk management has a key role in positioning RBS to prepare for, and respond to, developments in the wider competitive, economic and regulatory environment. Risk appetite is set in line with overall strategy and approved by the Board. Current and emerging risks, that could materially affect the delivery of the strategy, are identified and managed through the risk management framework.

Progress in 2017

RBS continued to make progress against its strategic objectives by reducing risk and strengthening both the balance sheet and the capital position.

There was a strong focus during 2017 on developing an enhanced operating model for the risk management function. This work aims to ensure the function continues to meet the needs of our evolving business as well as the structural requirements of the UK's ring-fencing legislation.

The merger of parts of the former Conduct & Regulatory Affairs function with RBS's Risk function took effect on 1 January 2017. This integration was designed to take advantage of synergies between the two functions. Work continued through the year to optimise these. In addition, there continued to be an emphasis on refining the risk appetite framework throughout 2017. As well as consolidating the progress made in previous years, further advances were made to enhance the framework in line with RBS's structural reform. Significant emphasis was placed on reviewing the current measures, along with associated limits and triggers, for each of our material risks and further embedding the reporting of risk profile compared to risk appetite across RBS.

Risk culture continued to be at the forefront of our activity as RBS moves towards its aim of making risk simply part of the way colleagues work and think. In support of this, during 2017 the RBS-wide action plan focused on building clarity, and developing capability. Work to standardise risk culture assessment and reporting has enabled progress to be measured across RBS as well as at an individual franchise and function level. In turn, this informed the risk culture element of performance reviews for RBS's Executive Committee.

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Throughout 2017, work continued to consolidate enhancements to the operational risk management framework. The framework plays a key role in helping RBS maintain a safe and secure environment for its customers and is central to the overall risk management strategy. There was an ongoing focus on risk and control assessment, particularly relating to the most material products, processes and services. Significant progress was made in strengthening the fraud defence framework and reducing fraud losses as a result of the successful implementation of various tactical and strategic solutions. The emphasis on understanding and managing the risks relating to RBS's transformation agenda remained a key theme during the year.

Cyber Security

In an increasingly digital landscape across the industry, cyber security continued to be a priority issue in 2017. RBS has a multi-layered defence approach and continues to invest in its defences as the external threat evolves. As part of this ongoing focus, a number of enhancements were made during the year ranging from improved protection of IT systems to mandatory awareness training for all employees. RBS has continued to participate in industry-wide initiatives to monitor and anticipate developments, identify vulnerabilities and share best practice. However, ongoing vigilance will be essential as the threat continues to evolve.

Open Banking

RBS welcomes the Competition & Markets Authority initiative to provide consumers with more choice and more control over their money and financial information by making it easier to compare the details of current accounts and other banking services. During 2017, oversight of the implementation programme was executed in parallel with a strategic assessment of the threats and opportunities in the mid- to long-term. Robust analysis and oversight will continue as the landscape evolves.

Innovation

RBS continues to embrace innovation in the field of financial technology. From the roll-out of the award-winning NatWest and Royal Bank of Scotland mobile app in 2011 to the launch, in 2017, of the NatWest Invest online investment advice service, developments with the potential to improve the banking experience are an integral element of the customer service proposition. Strong risk oversight has kept the security agenda at the forefront of these developments. Throughout the year RBS continued to focus on innovation while emphasising the importance of safety and protection for customers.

Financial Crime

Financial Crime was a key area of focus during 2017. The function continues to monitor the external environment and developments that could affect or change RBS's exposure to financial crime risk. In particular there was a focus on the anti-money-laundering control environment, with additional enhancements to policies and procedures to address the new regulatory requirements of the Fourth Money Laundering Directive. There was also a strong emphasis on the implementation of proportionate and risk-focused customer due diligence standards with an increased focus on the management of higher-risk customer segments. While progress was made during the year, more work is required and RBS continues on its journey of improvement in respect of these controls. Enhancements to sanctions screening were also introduced.

Anti-Bribery & Corruption (ABC) RBS is committed to ensuring it acts responsibly and ethically, both when

Our operating environment

pursuing its own business opportunities and when awarding business. Consequently it has embedded appropriate policies, mandatory procedures and controls to ensure its employees, and any other party it does business with, understand these obligations and abide by them, whenever they act for, or on behalf of, RBS. The requirements of RBS's ABC Policy apply to all RBS employees and non-employees, in every part of the business. All employees are required to complete ABC training on an annual basis, with targeted training appropriate for certain roles.

RBS considers ABC risk in its business processes where there could be a risk of offering an improper advantage or being perceived to do so. This includes, but is not limited to, corporate donations, charitable sponsorships, political activities and commercial sponsorships.

To mitigate against bribery and corruption risks, RBS's ABC policy and supporting mandatory procedures require employees to assess bribery and corruption risk, and conduct the appropriate level of ABC due diligence on business activities. Where appropriate, there is a requirement for ABC contract clauses in written agreements. In adopting this approach, RBS aims to protect the interests of its customers, shareholders and employees.

Reputational Risk

Reputational risk issues can develop from either strategic choices or conduct issues and may even arise from customer activity. RBS continues to remain alert to the reputational risk it is exposed to both in its day-to-day business and as a result of legacy issues. During 2017, further work was done to enhance the reputational risk framework and embed it across all business lines. This work will continue in 2018 as RBS continues to evolve its risk management practice to meet the challenges of the changing external environment.

Key Metrics

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Risk-weighted assets (RWAs) RWAs reduced by £27 billion (12%), ending the year at £201 billion (from £228 billion in 2016). This reduction was driven by NatWest Markets, where RWAs fell by £16.8 billion due to the continued run-off of the legacy business and mitigation activities in the core business, together with active management of the lending book in Commercial Banking.

Common Equity Tier 1 ratio

The CET1 ratio increased by 250 basis points to 15.9% in 2017. This was well above the 13% target and reflected the profit in the year and the RWA reductions in NatWest Markets and Commercial Banking.

Leverage ratios

The leverage ratio increased by 20 basis points to 5.3% during 2017 reflecting the increase in the CET1 position. The Bank of England leverage ratio increased by 50 basis points as a result of increased central bank reserves which are excluded from the leverage exposure measure.

Stress testing

Under the hypothetical adverse scenario in the Bank of England 2017 stress test, RBS's low-point CET1 ratio was below the CET1 ratio hurdle rate and the systemic reference point. Calculated after the impact of management actions, RBS's CET1 ratio was above the minimum requirement. The Tier 1 leverage ratio remained above the minimum requirement throughout the test.

As a result of the steps RBS had already taken to strengthen its capital position, a revised capital plan was not required by the PRA.

Liquidity and funding

RBS maintained a robust liquidity and funding risk profile in 2017. Its loan-to-deposit ratio was 88% at 31 December 2017, compared with 91% in 2016. The latest Internal Liquidity Adequacy Assessment Process (ILAAP) showed that RBS is in a strong position to withstand liquidity stress scenarios. It suggested that RBS's liquidity portfolio was large enough to cover more than 168% of the expected outflows in the worst of three severe scenarios.

Litigation and conduct

Litigation and conduct costs of £1,285 million included a £664 million provision in relation to various investigations and litigation matters relating to RBS's issuance and underwriting of residential mortgage-backed securities (RMBS) and additional PPI provision of £175 million. In July 2017 RBS reached a settlement with the Federal Housing Finance Agency (FHFA), as a result of which the FHFA's outstanding litigation against RBS relating to those securities was withdrawn. Further details on these issues can be found in the Litigation, Investigations & Reviews section.

Climate risk

While no climate-related risks have been identified that would have a major impact on RBS's strategy over a five-year horizon, RBS manages and monitors a number of associated threats. These include physical impacts, such as flooding, as well as the impact of climate-related regulation, though exposure to the sectors most vulnerable to climate risks, or climate-related regulation, has significantly reduced (for example RBS exposure to the power and oil & gas sectors has fallen to 1.2% of total lending exposures in 2017). RBS supports the work of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD). Adoption of the TCFD recommendations is an important step forward in pricing climate-related risks and opportunities as the transition to a low-carbon economy under the terms of the Paris Climate Agreement progresses.

Top and emerging risks

RBS employs a continuous process for identifying and managing its top and emerging risks. These are defined as scenarios that could have a significant negative impact on RBS's ability to operate. A number of scenarios attracted particular attention in 2017. The factors discussed below and elsewhere in this report should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties facing RBS.

Refer to the Risk Factors section on pages 349 to 379.

Macro-economic and political risks

RBS remains vulnerable to changes and uncertainty in the external economic and political environment, which have intensified in the past year. Stress testing and scenario planning is used extensively to inform strategic planning and risk mitigation relating to a range of macroeconomic and political risks. Scenarios identified as having a potentially material negative impact on RBS include: the impact of the UK's exit from the EU; a second Scottish independence referendum; a UK recession including significant

Our operating environment

falls in house prices; global financial market volatility linked to advanced economy interest rate increases or decreases; a protracted period of low interest rates in the UK; vulnerabilities in emerging market economies resulting in contagion in RBS's core markets; a eurozone crisis; and major geopolitical instability.

Risks related to the competitive environment

RBS's target markets are highly competitive, which poses challenges in terms of achieving some strategic objectives. Moreover, changes in technology, customer behaviour and business models in these markets have accelerated. RBS monitors the competitive environment and associated regulatory technological strategy development and makes adjustments as appropriate.

Impact of cyber attacks

Cyber attacks are increasing in frequency and severity across the industry. RBS has participated in industry-wide cyber attack simulations in order to help test and develop defence planning. To mitigate the risks, a number of control enhancements have been delivered as part of a bank-wide security programme. This has improved the protection of IT systems and data for both employees and customers. Further enhancements are underway and planned to ensure RBS continues to maintain an effective control environment as the cyber threats evolve.

Regulatory and legal risks

Future litigation and conduct charges could be substantial. RBS is involved in a number of litigation and investigations matters, including: ongoing class action litigation, securitisation and mortgage-backed securities related litigation, investigations into foreign exchange trading and rate-setting activities, continuing LIBOR-related litigation and investigations, and investigations into the treatment of small and medium-sized business customers in financial difficulty, anti-money laundering, sanctions, mis-selling (including mis-selling of payment protection insurance products). Settlements may result in additional financial penalties, non-monetary penalties or other consequences, which may be material.

More detail on these issues can be found in the Litigation, Investigations and Reviews and Risk Factors sections of the 2017 Annual Report on Form 20-F. To prevent future conduct from resulting in similar impacts, RBS continues to embed a strong and comprehensive risk and compliance culture.

Failure of information technology systems

RBS's information technology systems are complex. As such, recovering from failure is challenging. To mitigate these risks, a major investment programme has significantly improved the resilience of the systems and further progress is expected. System sustainability has improved as we continue to simplify and modernise our infrastructure and applications.

An increase in obligations to support pension schemes

The value of pension scheme assets may not be adequate to fund pension scheme liabilities. The actuarial deficit in the RBS pension schemes may therefore increase, requiring RBS to increase its current and future cash contributions. An acceleration of certain previously-committed pension contributions was made in Q1 2016 to reduce this risk. Depending on the economic and monetary conditions and longevity of scheme members prevailing at that time, the actuarial deficit may increase at subsequent valuations and is also expected to be affected by ring-fencing.

Operational and execution risks

Increased losses may arise from a failure to execute major projects successfully. These currently include the transformation plan, the restructuring of NatWest Markets, compliance with structural reform requirements including the statutory ring-fencing requirements implemented as a result of the Independent Commission on Banking and the implementation of obligations under the policy framework for resolution (including Operational Continuity in Resolution). These support the delivery of a robust control environment and the embedding of a strong and pervasive customer-centred organisational and risk culture, which are essential to meet RBS's strategic objectives. These projects cover organisation structure, business strategy, information technology systems, operational processes and product offerings. RBS continues to work to implement change in line with its project plans while assessing the risks to implementation and is taking steps to mitigate those risks where possible.

Risks to income, costs and business models arising from regulatory requirements

RBS is exposed to the risk of further increases in regulatory capital requirements as well as risks related to new regulations that could affect its business models.

RBS considers and incorporates the implications of proposed or potential regulatory activities in its strategic and financial plans.

Inability to recruit or retain suitable staff

There is a risk that RBS lacks sufficient capability or capacity at a senior level to deliver or to adapt to change. RBS monitors people risk closely and has plans in place to support retention of key roles, with wider programmes supporting engagement and training for all employees.

Governance at a glance

Board of directors

<p><u>Chairman</u></p> <p>Howard Davies</p>	<p><u>Executive directors</u></p> <p>Ross McEwan Ewen Stevenson</p>
<p><u>Non-executive directors</u></p> <p>Frank Dageard Alison Davis Morten Friis Robert Gillespie Penny Hughes Yasmin Jetha</p>	<p>Brendan Nelson Baroness Noakes Mike Rogers Mark Seligman (Senior Independent Director) Dr Lena Wilson</p>
<p><u>Company Secretary</u></p> <p>Aileen Taylor</p>	

Our Board

The Board has fourteen directors comprising the Chairman, two executive directors and eleven independent non-executive directors, one of whom is the Senior Independent Director. Biographies for each director can be found on pages 51 to 55.

The Board is collectively responsible for the long-term success of RBS and delivery of sustainable shareholder value. Its role is to provide leadership of RBS within a framework of prudent and effective controls which enables risks to be assessed and managed.

In 2017, the Board and committee evaluation process was conducted internally by the Deputy Secretary and Director, Corporate Governance, and overseen by the Company Secretary.

Our Board committees

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In order to provide effective oversight and leadership, the Board has established a number of Board committees with particular responsibilities. The work of the Board committees is discussed in their individual reports. The terms of reference for each of these committees is available on rbs.com.

The full Governance report is on pages 50 to 105 of the 2017 Annual Report on Form 20-F.

Group Audit Committee

Assists the Board in discharging its responsibilities for monitoring the quality of the financial statements of RBS. It reviews the accounting policies, financial reporting and regulatory compliance practices of RBS and RBS's systems and standards of internal controls, and monitors the work of internal audit and external audit.

Board Risk Committee

Provides oversight and advice to the Board on current and potential future risk exposures of RBS and future risk strategy. It reviews RBS's compliance with approved risk appetite and oversees the operation of the RBS Policy Framework and submissions to regulators.

Sustainable Banking Committee Provides support to the Board in overseeing actions being taken by management to run a sustainable long term business, with specific focus on culture, people, customer, brand and environmental social and ethical issues.

Group Performance and Remuneration Committee Responsible for approving remuneration policy and reviewing the effectiveness of its implementation. It also considers senior executive remuneration and makes recommendations to the Board on the remuneration of executive directors.

Group Nominations and Governance Committee

Assists the Board in the selection and appointment of directors. It reviews the structure, size and composition of the Board, and the membership and chairmanship of Board committees. It considers succession planning taking into account the skills and expertise which will be needed on the Board in future. Its remit also includes governance oversight.

Technology and Innovation Committee

The Technology and Innovation Committee was established in August 2017 and is responsible for assisting the Board in overseeing and monitoring execution of the Group's strategic direction in relation to technology and innovation.

Executive Committee

The Board is supported by the Executive Committee comprising the executive directors and other senior executives. It supports the Chief Executive in managing RBS's businesses. It reviews and debates relevant items before consideration by the Board. It is responsible for developing and delivering RBS's strategy and it monitors and manages financial performance, capital allocation, risk strategy and policy, risk management, operational issues and customer issues.

UK Corporate Governance Code

Throughout the year ended 31 December 2017, RBS has complied with all of the provisions of the UK Corporate Governance Code issued by the Financial Reporting Council dated April 2016 except in relation to provision (D.2.2) that the Group Performance and Remuneration Committee should have delegated responsibility for setting remuneration for the Chairman and executive directors. RBS considers that this is a matter which should rightly be reserved for the Board.

Governance

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Our Board

Chairman

Howard Davies

Nationality: British

Date of appointment: 14 July 2015 (Board),
1 September 2015 (Chairman)

Experience: Howard was Deputy Governor of the Bank of England from 1995 to 1997 and Chairman of the UK Financial Services Authority from 1997 to 2003. Howard was Director of the London School of Economics and Political Science from 2003 until May 2011. He is also Professor of Practice at the Paris Institute of Political Science (Sciences Po).

Howard was chair of the UK Airports Commission between 2012 and 2015 and is also the author of several books on financial subjects.

External appointment(s):

Independent director of Prudential plc and chair of the Risk Committee

Member of the Regulatory and Compliance Advisory Board of Millennium Management LLC

Chair of the International Advisory Council of the China Securities Regulatory Commission

Member of the International Advisory Council of the China Banking Regulatory Commission

Committee membership(s):

Group Nominations and Governance Committee (Chairman)

UBI DAC Board Oversight Committee (Chairman)

Executive directors

Chief Executive

Ross McEwan

Nationality: New Zealand

Date of appointment: 1 October 2013

Experience: Ross became Chief Executive of The Royal Bank of Scotland Group in October 2013.

Between August 2012 and September 2013, he was Chief Executive Officer for UK Retail, joining from Commonwealth Bank of Australia where he was Group Executive for Retail Banking Services for five years. Prior to this he was Executive General Manager with responsibility for the

External appointment(s):

None

Committee membership(s):

Executive Committee (Chairman)

branch network, contact centres and third party mortgage brokers.

Ross has more than 25 years experience in the finance, insurance and investment industries. Prior to Commonwealth Bank of Australia, he was Managing Director of First NZ Capital Securities. He was also Chief Executive of National Mutual Life Association of Australasia Ltd/AXA New Zealand Ltd.

Chief Financial Officer

Ewen Stevenson

External appointment(s):

Nationality: British/New Zealand

None

Date of appointment: 19 May 2014

Committee membership(s):

Experience: Prior to his current role, Ewen was at Executive Committee Credit Suisse for 25 years where he was latterly co-Head of the EMEA Investment Banking Division and co-Head of the Global Financial Institutions Group. He has over 20 years of experience advising the banking sector while at Credit Suisse.

Ewen has a Bachelor of Commerce and Administration majoring in Accountancy and a Bachelor of Law from Victoria University of Wellington, New Zealand.

Our Board

Independent non-executive directors

Frank Dangeard

External appointment(s):

Nationality: French

Non-executive director of the RPX Corporation

Date of appointment: 16 May 2016

Non-executive director of Symantec Corporation

Experience: Previously, Frank served as a non-executive director of Crédit Agricole CIB, EDF, Home Credit, Orange, Sonaecom SGPS, and as Deputy Chairman and acting Chairman of Telenor ASA. During his executive career he held various roles at Thomson S.A., including Chairman and Chief Executive Officer, and was Deputy Chief Executive Officer of France Telecom. Prior to that he was Chairman of SG Warburg France and a Managing Director of SG Warburg.

Committee membership(s):

Board Risk Committee
Technology and Innovation Committee

Frank is a graduate of HEC and IEP in Paris and of the Harvard Law School in the US.

Alison Davis

External appointment(s):

Nationality: British/USA

Non-executive director and member of the audit and compensation committees of Unisys Corporation

Date of appointment: 1 August 2011

Non-executive director, and member of the audit committee of Fiserv Inc

Experience: Previously, Alison served as a director of City National Bank, First Data Corporation, Xoom, Presidio Bank, Diamond foods and a non-executive director and chair of the board of LECG Corporation. She has also worked at McKinsey & Company, AT Kearney, as Chief Financial Officer at Barclays Global Investors (now BlackRock) and as managing partner of Belvedere Capital, a private equity firm focused on buy-outs in the financial services sector.

Non-executive director and chair of the audit committee of Ooma Inc

Committee membership(s):

Technology and Innovation Committee (Chairman)

Group Performance and Remuneration
Committee

Alison is a graduate of Cambridge University and
Stanford Business School.

Sustainable Banking Committee

Morten Friis

External appointment(s):

Nationality: Norwegian

Member of the Board of Directors of The
Canadian Institute for Advanced Research

Date of appointment: 10 April 2014

Member of the Board of Directors of the Harvard
Business School Club of Toronto

Experience: Previously, Morten had a 34 year
financial services career and held various roles at
Royal Bank of Canada and its subsidiaries
including Associate Director at Orion Royal Bank,
Vice President, Business Banking and Vice
President, Financial Institutions. In 1997, he was
appointed as Senior Vice President, Group Risk
Management and served as the Chief Credit
Officer then Chief Risk Officer from 2004 to 2014.
He was also previously a Director of RBC Bank
(USA), Westbury Life Insurance Company, RBC
Life Insurance Company and of RBC Dexia
Investor Services Trust Company.

Non-executive director of Jackson National Life
Insurance Company

Committee membership(s):

Group Audit Committee

Board Risk Committee

Our Board

Independent non-executive directors

Robert Gillespie

Nationality: British

Date of appointment: 2 December 2013

Experience: Robert began his career with Price Waterhouse (now PricewaterhouseCoopers) where he qualified as a chartered accountant. He then moved into banking joining SG Warburg, specialising in corporate finance, and was appointed as Co-Head and Managing Director of its US investment banking business in 1989. Following the acquisition in 1995 of Warburg by Swiss Bank Corporation (which subsequently merged with UBS), he then held the roles of Head of UK Corporate Finance, Head of European Corporate Finance and Co-Head of its global business and CEO of the EMEA region. He relinquished his management roles at the end of 2005, and was appointed Vice Chairman of UBS Investment Bank. Robert left UBS to join Evercore Partners, from where he was seconded to the UK Panel on Takeovers and Mergers, as Director General, from 2010 to 2013.

External appointment(s):

Independent board director at Ashurst LLP

Chairman of Council at the University of Durham

Chairman of the Boat Race Company Limited

Director of Social Finance Limited

Committee membership(s):

Group Nominations and Governance Committee

Group Performance and Remuneration Committee (Chairman)

Sustainable Banking Committee

GRG Board Oversight Committee

Penny Hughes, CBE

Nationality: British

Date of appointment: 1 January 2010

Experience: Previously a non-executive director and chairman of the corporate compliance and responsibility committee of Wm Morrison Supermarkets plc. Other former non-executive directorships include Skandinaviska Enskilda Banken AB, Home Retail Group plc, Vodafone Group plc, Reuters Group PLC, Cable & Wireless Worldwide plc and The Gap Inc. Penny spent the majority of her executive career at Coca-Cola where she held a number of leadership positions, latterly as President, Coca-Cola Great Britain and

External appointment(s):

Non-executive Chairman of The Gym Group plc. Also chair of the nominations and member of the audit, risk and remuneration committees

Non-executive director, chairman of the remuneration committee and member of the audit and nomination committees of Superdry plc

Non-executive Chairman of IQSA Group Limited

Committee membership(s):

Sustainable Banking Committee (Chairman)

Ireland.

Board Risk Committee

GRG Board Oversight Committee

Group Nominations and Governance Committee

Our Board

Independent non-executive directors

Yasmin Jetha

Nationality: British

Date of appointment: 21 June 2017

Experience: Previously a non-executive director designate of Williams & Glyn. During her executive career, Yasmin held Chief Information Officer roles at Bupa and the Financial Times, where she became the Chief Operating Officer. She previously had a career spanning nearly 20 years at Abbey National PLC, latterly serving as an Executive Director on the board.

External appointment(s):

Non-executive director of Guardian Media Group plc

Non-executive director of Nation Media Group (East Africa)

Independent panel member of the Cabinet Office Major Projects Review Group

Committee membership(s):

Sustainable Banking Committee

Technology and Innovation Committee

Brendan Nelson

Nationality: British

Date of appointment: 1 April 2010

Experience: Brendan was global Chairman, financial services for KPMG. He previously held senior leadership roles within KPMG including as a member of the KPMG UK board from 1999 to 2006 and as vice-Chairman from 2006 until his retirement in 2010. He was Chairman of the Audit Committee of the Institute of Chartered Accountants of Scotland from 2005 to 2008. President of the Institute of Chartered Accountants of Scotland 2013/14.

External appointment(s):

Non-executive director and Chairman of the audit committee and member of the remuneration and chairman s committees of BP plc

Member of the Financial Reporting Review Panel

Committee membership(s):

Group Audit Committee (Chairman)

Group Nominations and Governance Committee

Board Risk Committee

GRG Board Oversight Committee (Chairman)

UBI DAC Board Oversight Committee

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Baroness Noakes, DBE

External appointment(s):

Nationality: British

Deputy Chairman, Ofcom

Date of appointment: 1 August 2011

Committee membership(s):

Experience: Baroness Noakes is an experienced director on UK listed company boards with extensive and varied political and public sector experience. A qualified chartered accountant, she previously headed KPMG's European and International Government practices and has been President of the Institute of Chartered Accountants in England and Wales. She was appointed to the House of Lords in 2000 and has served on the Conservative front bench in various roles including as shadow treasury minister between 2003 and May 2010. Previously held non-executive roles on the Court of the Bank of England, Hanson, ICI, Severn Trent, Carpetright, John Laing and SThree.

Board Risk Committee (Chairman)

Group Audit Committee

GRG Board Oversight Committee

Group Nominations and Governance Committee

UBI DAC Board Oversight Committee

Our Board

Independent non-executive directors

Mike Rogers

Nationality: British

Date of appointment: 26 January 2016

Experience: Mike has extensive experience in retail banking and financial services. Mike joined Barclays in 1986 where he undertook a variety of roles in the UK and overseas across business banking, wealth management and retail banking. Mike was Managing Director of Small Business, Premier Banking and UK Retail Banking and was latterly Chief Executive of Liverpool Victoria Group for 10 years.

External appointment(s):

Non-executive Chairman of Aegon UK

Director of Experian plc and Chairman- designate of its Remuneration Committee

Committee membership(s):

Group Performance and Remuneration Committee

Sustainable Banking Committee

Mark Seligman

Nationality: British

Date of appointment: 1 April 2017

(Senior Independent Director since 1 January 2018)

Experience: Mark, is a former senior investment banker with broad financial services knowledge, has substantial FTSE 100 Board experience gained in various industry sectors, including as a Committee Chair and Senior Independent Director.

External appointment(s):

Senior Independent Director of Kingfisher plc

Non-Executive Director and chairman of the audit committee of Smiths Group plc

Committee membership(s):

Group Nominations and Governance Committee

Group Performance and Remuneration Committee

UBI DAC Board Oversight Committee

During his executive career, he held various senior roles at Credit Suisse/BZW (including Deputy Chairman, CSFB Europe and Chairman, UK Investment Banking, CSFB); and previously SG Warburg (ultimately as Managing Director, Head of Advisory).

He has also previously served as a non-executive Director of BG Group plc and as Deputy Chairman of G4S plc.

Dr Lena Wilson, CBE

External appointment(s):

Nationality: British

Non-Executive Director of Intertek Group plc, and member of its audit and nomination committees.

Date of appointment: 1 January 2018

Non-Executive Director of Scottish Power Renewables Limited

Experience: Experience: Lena is an experienced CEO with an international career, who spent a significant proportion of her executive career with Scottish Enterprise, latterly as Chief Executive from 2009 until 2017. Prior to that, Lena held the role of Senior Investment Advisor to The World Bank in Washington DC. Dr Wilson is a visiting Professor at the University of Strathclyde and has previously served as a member of Scotland's Financial Services Advisory Board and as Chair of Scotland's Energy Jobs Taskforce. In June 2015 she received a CBE for services to economic development in Scotland.

Committee membership(s):

Sustainable Banking Committee

Our Board

Chief Governance & Regulatory Officer and Board Counsel

Aileen Taylor

Nationality: British

Date of appointment: 1 May 2010

(Company Secretary)

Aileen is a fellow of the Chartered Institute of Bankers in Scotland and a member of the European Corporate Governance Council. She is also a member of the FCA's Listing Authority Advisory Panel.

Experience: A qualified solicitor, Aileen joined RBS in 2000. She was appointed Deputy Group Secretary and Head of Group Secretariat in 2007, and prior to that held various legal, secretariat and risk roles including Head of External Risk (Retail), Head of Regulatory Risk (Retail Direct) and Head of Legal and Compliance (Direct Line Financial Services).

Executive Committee

The Board is supported by the Executive Committee comprising the executive directors and other senior executives. Details of the composition of the Executive Committee and biographies of its members can be found at [rbs.com/about us/board and governance/ceo and board/executive committee](http://rbs.com/about-us/board-and-governance/ceo-and-board/executive-committee).

Corporate governance

Chairman's introduction

The corporate governance report provides an overview of key roles and responsibilities of the Board, how the Board spent its time in 2017 and how we communicate with shareholders. Board effectiveness and performance evaluation are also covered.

As mentioned in my Chairman's Statement on page 7, during 2017 the Board has considered a number of key strategic, financial, regulatory and risk matters together with legacy issues such as Williams & Glyn; Global Restructuring Group (GRG); and various litigation matters including the 2008 shareholders' rights issue litigation. The Board has also been able to spend time focussing on forward-looking matters, including ring-fencing preparations; innovation; technology; and culture. The establishment of the Board's Technology and Innovation Committee will further support our focus on the Group's future strategic direction.

During 2017 we made a number of changes to our Board and committee composition, to support our preparations for ring-fencing and to ensure orderly succession planning. Further details are set out below under Board and committee changes.

On 28 July 2017, the Group Board Directors were appointed to the Board of Ulster Bank Limited (UBL) and the existing Directors of UBL stepped down. This common board and committee structure with Group, RBS plc and NatWest promotes simplification and efficiencies.

I and my fellow directors are committed to observing high standards of corporate governance, integrity and professionalism. Our statement of compliance with the UK Corporate Governance Code (the Code) can be found on page 106.

I would like to take this opportunity to thank my fellow Directors for their continued commitment and dedication throughout 2017.

Howard Davies, Chairman of the Board

The Board

The Board has fourteen directors comprising the Chairman, two executive directors and eleven independent non-executive directors, one of whom is the Senior Independent Director.

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Biographies for each director and details of which Board committees they are members of can be found on pages 51 to 55. The Board considers that the Chairman was independent on appointment and that all non-executive directors are independent for the purposes of the Code.

Board and committee changes

A number of changes were made to Board and committee composition during 2017, as follows:

- Mark Seligman was appointed as a non-executive director on 1 April 2017.
- Yasmin Jetha was appointed as a non-executive director on 21 June 2017, and became a member of the Sustainable Banking Committee with effect from 3 August 2017.
- With effect from 3 August 2017 Baroness Noakes, Penny Hughes and Mark Seligman were appointed members of the Group Nominations & Governance Committee and Alison Davis stepped down.
- On 1 September 2017 the Technology and Innovation Committee was established with Alison Davis as Chairman and Yasmin Jetha and Frank Dangeard as members.

John Hughes was also appointed as a non-executive director on 21 June 2017, but unfortunately resigned on 1 September 2017 due to health reasons.

Also, with effect from 1 January 2018:

- Sandy Crombie stepped down as a non-executive director of RBS, and as Senior Independent Director and Chairman of the Group Performance & Remuneration Committee;
- Mark Seligman assumed the role of Senior Independent Director and became a member of the Group Performance & Remuneration Committee;
- Robert Gillespie assumed the role of Chairman of the Group Performance & Remuneration Committee; and
- Dr Lena Wilson joined the board as a non-executive director.

Dr Wilson became a member of the Sustainable Banking Committee with effect from 31 January 2018.

In addition, with effect from close of business of the 2018 Annual General Meeting, Penny Hughes will step down as a non-executive director of RBS and Chairman of the Sustainable Banking Committee. Mike Rogers will assume the role of Chairman of the Sustainable Banking Committee.

Roles and responsibilities

The Board

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The Board is collectively responsible for the long-term success of RBS and delivery of sustainable shareholder value. The terms of reference include a formal schedule of matters specifically reserved for the Board's decision and are reviewed at least annually. They are available at rbs.com/about.

A number of Board members are designated as Senior Managers under the PRA and FCA's Senior Managers Regime. The role profiles of relevant directors reflect their regulatory responsibilities and they receive ongoing support to ensure they can demonstrate the reasonable steps they have taken to meet their responsibilities. This support includes a practical handbook for non-executive directors on the Senior Managers Regime.

Chairman

The role of Chairman is distinct and separate from that of the Chief Executive and there is a clear division of responsibilities with the Chairman leading the Board and the Chief Executive managing RBS business day to day.

Corporate governance

The Chairman's key responsibilities are to:

- provide strong and effective leadership to the Board;
- ensure the Board is structured effectively, observes the highest standards of integrity and corporate governance, and sets the tone from the top in terms of culture and values;
- build an effective and complementary Board with an appropriate balance of skills and personalities, and as Chairman of the Group Nominations and Governance Committee consider succession planning for Board appointments;
- foster open and inclusive discussions at each Board / Committee meeting which challenge executives, where appropriate;
- in conjunction with the Chief Executive and Company Secretary, ensure that members of the Board receive accurate, timely and clear information to enable the Board to lead RBS, take sound decisions and monitor effectively the performance of executive management;
- ensure that the performance of individual directors and of the Board as a whole and its committees is evaluated regularly; and
- ensure RBS maintains effective communication with shareholders and other stakeholders.

Chief Executive

The Chief Executive has responsibility for all of RBS's business and acts in accordance with the authority delegated by the Board.

The Chief Executive's key responsibilities are to:

- exercise executive accountability for the RBS businesses delivering operational management and oversee the full range of activities of the customer businesses and functions;
- develop, drive and deliver the strategy approved by the Board;
- drive and deliver performance against financial plans, acting in accordance with authority delegated by the Board;
- consult regularly with the Chairman and Board on matters which may have a material impact on RBS;
- lead the culture and values of RBS, creating an environment where employees are engaged and committed to good customer outcomes;

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- lead, manage and develop RBS's senior leadership team, ensuring professional capability is developed and that succession coverage meets the needs of RBS;
- ensure RBS has effective frameworks and structures to identify, assess and mitigate risks; and
- in conjunction with the Chairman and Company Secretary, ensure the Board receives accurate, timely and clear information.

Senior Independent Director

Throughout 2017 Sandy Crombie, as Senior Independent Director, acted as a sounding board for the Chairman and as an intermediary for other directors when necessary. He was also available to shareholders to discuss any concerns they may have, as appropriate. Mark Seligman assumed the role and responsibilities of Senior Independent Director with effect from 1 January 2018.

Non-executive directors

Along with the Chairman and executive directors, the non-executive directors are responsible for ensuring the Board fulfils its responsibilities under its terms of reference. The non-executive directors combine broad business and commercial experience with independent and objective judgement and they provide independent challenge to the executive directors and the leadership team. The balance between non-executive and executive directors enables the Board to provide clear and effective leadership across RBS's business activities.

The standard terms and conditions of appointment of non-executive directors are available on rbs.com or from RBS Corporate Governance and Regulatory Affairs.

Board Committees

In order to provide effective oversight and leadership, the Board has established a number of Board committees with particular responsibilities. Refer to page 49 of the Strategic Report for more details. The terms of reference are available on rbs.com.

The GRG Board Oversight Committee was established in 2015 in relation to the Financial Conduct Authority review of the treatment of SME customers and continued to meet during 2017. The Committee oversees and provides advice to the Board in relation to the review, the external independent review of GRG instigated by the Group and other matters generally related to GRG.

The US Risk Committee was disbanded in May 2017 following the closure of the Connecticut branch.

A Board Oversight Committee was established in September 2017 in order to provide oversight of required enhancements to the governance and risk management practices within Ulster Bank Ireland DAC (UBI DAC), reporting to the Board, as appropriate.

The NatWest Markets Working Group has continued to oversee the transition towards establishment of the board of NatWest Markets Plc which will be stood up in 2018.

Company Secretary

Aileen Taylor is the Company Secretary. Aileen also leads the Bank's Regulatory Affairs function.

The key responsibilities of the Company Secretary include:

- working closely with the Chairman to ensure effective functioning of the Board and appropriate alignment and information flows between the Board and its committees, including the Executive Committee. This includes Board succession planning, induction, and professional development;
- providing support and advice to the Board on a broad range of strategic, governance, legal and regulatory issues;
- executive responsibility for Chairman/non-executive director search and appointment process;
- management of RBS's profile with key stakeholders, including oversight of relations with key influencers and regulators;
- defining and delivering the corporate governance and regulatory affairs strategy across RBS; and
- the provision of professional support to the Board and its committees and leading on implementation of recommendations from the annual Board evaluation.

Corporate governance

Conflicts of interests

RBS has procedures in place to ensure that the Board's management of conflicts of interest and its powers for authorising certain conflicts are operating effectively. On appointment, each director is provided with RBS's guidelines for referring conflicts of interest to the Board. Each director is required to notify the Board of any actual or potential situational or transactional conflict of interest and to update the Board with any changes to the facts and circumstances surrounding such conflicts.

Situational conflicts can be authorised by the Board in accordance with the Companies Act 2006 and the company's Articles of Association. The Board considers each request for authorisation on a case by case basis and has the power to impose conditions or limitations on any authorisation granted as part of the process.

Details of all directors' conflicts of interest are recorded in a register which is maintained by the Company Secretary and reviewed annually by the Board.

Board meetings

In 2017, 9 Board meetings were scheduled and individual attendance by directors at these meetings is shown in the table below.

In addition to the 9 scheduled meetings, 9 additional meetings and committees of the Board were held, including meetings to consider and approve financial statements. The Chairman and the non-executive directors meet at least once per year without executive directors present.

	Attended/ scheduled
Howard Davies	9/9
Ross McEwan	9/9
Ewen Stevenson	9/9
Frank Dangeard	9/9
Alison Davis	9/9
Morten Friis	9/9
Robert Gillespie	9/9
Penny Hughes	9/9
Yasmin Jetha (1)	5/5
Brendan Nelson	9/9
Baroness Noakes	9/9
Mike Rogers	9/9
Mark Seligman (2)	6/6
Former Directors	

Sandy Crombie (3)
John Hughes (4)

9/9
2/2

Notes:

- (1) Appointed to the Board on 21 June 2017.
- (2) Appointed to the Board on 1 April 2017.
- (3) Stepped down from the Board with effect from 1 January 2018.
- (4) Appointed to the Board on 21 June 2017 and stepped down from the Board on 1 September 2017.

Principal areas of Board focus during 2017

In advance of each Board meeting, the directors are provided with comprehensive papers.

At each scheduled Board meeting the directors received reports from the Chairman, Chief Executive, Chief Financial Officer, Chief Risk Officer, Chief Operating Officer, Chief Administration Officer, Franchise CEOs, General Counsel and the Board Committee Chairmen. Other relevant senior executives attend Board meetings to present reports to the Board as appropriate. This provides the Board with an opportunity to engage directly with management on key issues and supports the Board's succession planning activity.

An overview of the principal areas of Board focus during 2017 is set out below.

Customer & Culture

- customer service
- open banking and innovation
- branch network strategy
- payments strategy
- customer metrics
- branding, communications and marketing updates
- overseeing culture and quarterly culture updates
- external fraud update
- Banking Standards Board assessments

Finance

- annual financial budget and plan
- capital strategy and planning
- Internal Capital Adequacy Assessment Process
- Individual Liquidity Adequacy Assessment Process
- dividend planning and policy
- pension strategy
- tax strategy
- mergers and acquisition strategy
- recovery and resolution planning
- results and analysts presentations
- IFRS 9 accounting policies
- legal entity capability and plans

Corporate governance

Strategy

- annual Board strategy offsite and deep dives into each of the franchises
- Brexit implications and response planning
- structural reform, including ring-fencing and legal entity transfers
- transformation programme
- Williams & Glyn alternative remedies package and re-integration

Risk & Conduct

- stress testing
- risk appetite governance and framework
- annual review of strategic risk appetite
- preventing the facilitation of tax evasion

Legal, Regulatory & Governance

- Annual Report and Accounts
- AGM arrangements
- Board appointments
- Board policies, including Board Appointments and Boardroom Inclusion
- Board and Committee evaluations
- annual PRA presentation to the Board

- external auditor evaluation
- Individual Accountability Regime: embedding and ring-fencing implications
- internal audit evaluation
- Modern Slavery Act

Human Resources

- internal employee survey results
- executive director remuneration proposals
- executive director performance and pay review
- executive succession planning
- health and safety

The Board also visited the RBS International (RBSI) business in Jersey in September 2017. The agenda included a deep dive on the RBSI business, strategy, risks and challenges, and directors also met with key customers and local businesses.

In October 2017, an event for subsidiary non-executive directors provided a useful opportunity for subsidiary non-executive directors to gain a broader knowledge of the Group and education on areas of interest as well as providing a deeper understanding of their roles and responsibilities within the Group. A Board reception was also held at Gogarburn in October 2017, during which directors were able to meet and spend time with RBS customers, stakeholders and other influencers.

Board effectiveness

Skills and experience of the Board

The Board is structured to ensure that the directors provide RBS with the appropriate balance of skills, experience and knowledge as well as independence. Given the nature of RBS s businesses, experience of banking and financial services is clearly of benefit, and we have a number of directors with substantial experience in that area. The Board also benefits from directors with experience in other fields.

The table below illustrates the breadth of skills and experience on the Board.

• Retail banking	• Chief executive experience
• Broad financial services	• Finance and accountancy
• Commercial & Private Banking	• Risk

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• Markets/investment Banking	• Technology (infrastructure)
• Government and regulatory	• Digital and innovation
• Mergers and acquisitions	• Operations
• Corporate restructuring	• Change management
• Stakeholder management	• Consumer facing

Board committees also comprise directors with a variety of skills and experience so that no undue reliance is placed on any individual.

Induction and professional development

Each new director receives a formal induction on joining the Board, which is co-ordinated by the Company Secretary. This includes visits to RBS's major businesses and functions and meetings with directors and senior management. Meetings with external auditors, counsel and stakeholders are also arranged as appropriate. An illustrative list of the meetings arranged during a new director's induction programme is set out below:

• Chairman	• Chief Human Resources Officer
• Chief Executive	• Chief Administrative Officer
• Chief Financial Officer	• Head of Investor Relations
• Senior Independent Director	• Head of Public and Consumer Affairs
• Other non-executive directors	• Head of Recovery and Resolution Planning
• Company Secretary	• Director of Strategy & Corporate Development
• Chief Risk Officer	• Director of Transformation
• Chief Marketing Officer	• Head of Restructuring
• Chief Operating Officer	• Chief Economist
• RBS Treasurer	• External Auditors
• Chief Audit Executive	• External Counsel
• Chief Legal Officer and General Counsel	• Regulators
• Chairmen and CEOs of principal subsidiaries	• Business visits (UK and
• Franchise Chief Executive Officers	
• Deputy Chief Financial Officer	

• Chief Accountant	overseas)
• Head of RBS Tax	

Corporate governance

The directors have access to a wide range of briefing and training sessions and other professional development opportunities. Internal training relevant to the business of RBS is also provided. Business visits are arranged as part of the Group Audit Committee and Board Risk Committee schedule (details of which can be found on pages 67 and 74) and all non-executive directors are invited to attend. Non-executive directors are also welcome to attend the stakeholder engagement sessions run by the Sustainable Banking Committee (further details of which are on page 82).

Directors undertake the training they consider necessary to assist them in carrying out their duties and responsibilities as directors. Directors may also request individual in-depth briefings from time to time on areas of particular interest.

During 2017, the directors received updates on a range of subjects to enhance their knowledge, including:

- RBS customer service excellence programme training
- Financial Crime and anti-money laundering training, including Criminal Finances Act 2017
- Embracing Innovation and Disruption
- Diversity and inclusion
- UK Corporate Governance Reform agenda
- Stakeholder engagement
- Remuneration developments
- General Data Protection Regulation
- Reporting on Payment Practices and Performance Regulations 2017
- Structural Reform

In addition, all directors have access to an online resources portal, which contains internal policy information and external briefing notes on topical subjects, to support their professional development and competence.

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The Company Secretary maintains continuing professional development logs. These are reviewed regularly between the Chairman and each director individually, to assist in identifying future training and development opportunities that are specific to the individual director's requirements.

Information

All directors receive accurate, timely and clear information on all relevant matters and have access to the advice and services of the Company Secretary. In addition, all directors are able, if necessary, to obtain independent professional advice at the company's expense.

Time commitment

It is anticipated that non-executive directors will allocate sufficient time to RBS to discharge their responsibilities effectively and will devote such time as is necessary to fulfil their role. Directors have been briefed on the limits on the number of other directorships that they can hold under the requirements of the fourth Capital Requirements Directive (CRD IV).

Each director is required to advise RBS as early as possible and to seek the agreement of the Board before accepting additional commitments that might affect the time the director is able to devote to his or her role as a non-executive director of RBS. The Board monitors the other commitments of the Chairman and directors and is satisfied that they are able to allocate sufficient time to enable them to discharge their duties and responsibilities effectively. The time commitment currently required of our non-executive directors continues to be significant.

Election and re-election of directors

In accordance with the provisions of the Code, all directors stand for election or re-election by shareholders at the company's Annual General Meeting. In accordance with the UK Listing Rules, the election or re-election of independent directors also requires approval by a majority of independent shareholders.

Performance evaluation

In accordance with the Code, an external evaluation of the Board takes place every three years. An internal evaluation takes place in the intervening years. The most recent external evaluation of the Board was conducted in 2015.

Progress following the 2016 evaluation

A number of actions were progressed during 2017 in response to the findings of the 2016 performance evaluation, overseen by the Group Nominations & Governance Committee.

These included further enhancement of the Board's composition with the appointments of Mark Seligman and Yasmin Jetha, and the introduction of a Board Appointment Policy to support succession planning. Work continued on improving the quality of information provided to the directors and the 2017 Board agenda reflected directors' feedback on agenda balance and priorities. The Board continued to dedicate significant time to culture and customers, and this focus will continue into 2018. In conclusion, the specific actions identified during the 2016 evaluation have been appropriately addressed, and where high level themes remain relevant, these have been appropriately incorporated into the 2017 action plan.

2017 Performance evaluation process

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In 2017, the Board and committee evaluation process was conducted internally by the Deputy Secretary and Director, Corporate Governance, and overseen by the Company Secretary.

The Deputy Secretary and Director, Corporate Governance undertook a formal and rigorous evaluation by:

- preparing surveys that were completed by each director and holding interviews with each director;
- discussing the key themes and recommendations for action with the Chairman; and
- recommending the key themes and proposed actions to the Board.

Corporate governance

Outcomes of the 2017 performance evaluation

The conclusion of the 2017 performance evaluation was that the Board operated effectively throughout the year and fulfilled its remit as set out in its terms of reference.

Positive feedback was provided in relation to the operation of the Board, including its composition, focus of the agenda, the Chairman's leadership, meeting dynamics and the support the Board receives.

Key themes and findings arising from the evaluation included:-

Strategy

As legacy matters reach their conclusion, the Board has an opportunity to devote more of its time to discussing forward looking strategy.

Customers

Acknowledging the work of the Sustainable Banking Committee in this area, the general consensus was that there is scope for even greater focus on customers at Board level.

Risk

Noting the work of the Board Risk Committee, it was agreed that continued Board focus on major strategic risks should remain a priority.

Engagement with management

It was agreed that the Board provides effective challenge and oversight to management and the importance of continuing to balance the Board's challenge / oversight role with providing appropriate support to management was also highlighted.

Executive succession planning

There is appetite at Board level for greater focus on Executive Committee succession and talent development.

Board information and time commitment

Acknowledging the progress made during 2017, it was noted that there remains room for improvement in length and timeliness of papers. The length of committee meetings was also raised in the context of directors' time commitment.

Next steps

A detailed action plan has been developed in response to the themes and findings during the 2017 evaluation, and its implementation will be overseen by the Group Nominations & Governance Committee during 2018.

Individual director and Chairman effectiveness reviews

The Chairman met with each director individually to discuss their own performance and ongoing professional development and also shared peer feedback provided as part of the evaluation process. Separately, the Senior Independent Director sought feedback on the Chairman's performance from the non-executive directors, executive directors and key external stakeholders and discussed it with the Chairman.

Relations with investors

The Chairman is responsible for ensuring effective communication with shareholders. The company communicates with shareholders through the Annual Report and Accounts and by providing information in advance of the Annual General Meeting. Individual shareholders can raise matters relating to their shareholdings and the business of RBS at any time throughout the year by letter, telephone or email via rbs.com/ir.

Shareholders are given the opportunity to ask questions at the Annual General Meeting and any General Meetings held or can submit written questions in advance. The Senior Independent Director and the chairmen of the Board committees are available to answer questions at the Annual General Meeting.

During 2017, RBS also held events in Edinburgh and London for our retail shareholders. Further details can be found on page 29 of the Strategic Report.

Communication with the company's largest institutional shareholders is undertaken as part of the Investor Relations programme:

- the Chief Executive and Chief Financial Officer meet regularly with UKFI, the organisation set up to manage the Government's investments in financial institutions, to discuss the strategy and financial performance of the business. The Chief Executive and Chief Financial Officer also undertake an extensive annual programme of meetings with the company's largest institutional shareholders;
- the Chairman independently meets with RBS's largest institutional shareholders annually to hear their feedback on management, strategy, business performance and corporate governance. Additionally, the Chairman and Senior Independent Director met with the governance representatives of a number of institutional shareholders during the year;
- the Senior Independent Director is available if any shareholder has concerns that they feel are not being addressed through the normal channels; and
- the Chairman of the Group Performance and Remuneration Committee consults with major shareholders in respect of the Group's remuneration policy.

Throughout the year, the Chairman, Chief Executive, Chief Financial Officer and Chairman of the Group Performance and Remuneration Committee communicate shareholder feedback to the Board. The directors also receive reports reviewing share price movements and performance against the sector. Detailed market and shareholder feedback is provided to the Board after major public announcements such as a results release. The arrangements in place are to ensure that directors develop an understanding of the views of major shareholders.

The Investor Relations programme also includes communications aimed specifically at its fixed income (debt) investors. The Chief Financial Officer and/or the RBS Treasurer give regular presentations to fixed income investors to discuss strategy and financial performance. There is also a separate section on the RBS website for fixed income investors which includes information on credit ratings, securitisation programmes and securities documentation. Further information is available at rbs.com/ir.

Report of the Group Nominations and Governance Committee

Letter from Howard Davies

Chairman of the Group Nominations and Governance Committee

Dear Shareholder,

As Chairman of the Board and Chairman of the Group Nominations and Governance Committee I am pleased to present our report on the committee's activity during 2017.

Role and responsibilities

The Group Nominations and Governance Committee was constituted in January 2016 and assumed the responsibilities of the previous Group Nominations Committee to review the structure, size and composition of the Board, and membership and chairmanship of Board Committees. In addition, the Committee monitors the Group's governance arrangements to ensure that best corporate governance standards and practices are upheld and considers developments relating to banking reform and analogous issues affecting the Group in the markets where it operates. The Committee makes recommendations to the Board in respect of any consequential amendments to the Group's operating model.

The Committee engages with external consultants, considers potential candidates and recommends appointments of new directors to the Board.

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The terms of reference of the Group Nominations and Governance Committee are reviewed annually, approved by the Board and are available at rbs.com.

Principal activity during 2017

As highlighted in the Board's 2016 performance review, the Committee acknowledges the tenure of a number of the current Board directors and therefore made succession planning a priority in 2017.

In addition to recruitment, the Committee continues to oversee the process to reach agreement with the PRA in respect of a governance model that is compatible with ring-fencing legislation. Ring-fencing also gives rise to a requirement to recruit additional non-executive directors to the boards of our material regulated subsidiaries, which the Committee has overseen.

The Committee has spent time considering the Group's arrangements in respect of legal entity governance. This work continues and is complementary to the Group's preparations for the implementation of ring-fencing legislation.

The Committee has overseen the establishment of the Group's Technology and Innovation Committee, which was constituted on 1 September 2017 with a remit to assist the Board in overseeing and monitoring execution of the Group's strategic direction in relation to technology and innovation.

Membership and meetings

For most of 2017, the Group Nominations and Governance Committee comprised the Chairman of the Board and four independent non-executive directors. In August 2017, the Committee composition was amended to include the Senior Independent Director, as well as the Chairmen of the Board Risk Committee, Group Audit Committee, Group Performance & Remuneration Committee and Sustainable Banking Committee. Alison Davis stood down from the Committee in August 2017, simultaneous with her appointment as Chairman of the Technology and Innovation Committee. Sandy Crombie stepped down from the Committee with effect from 1 January 2018.

The Committee holds at least four scheduled meetings per year and also meets on an ad hoc basis as required. In 2017, there were seven meetings. Individual attendance by directors at these meetings is shown in the tables below.

	Attended/ scheduled
Howard Davies (Chairman)	7/7
Robert Gillespie	7/7
Penny Hughes (1)	1/2
Brendan Nelson	7/7
Baroness Noakes (2)	2/2
Mark Seligman (3)	2/2
Former Members	
Sandy Crombie (4)	7/7
Alison Davis (5)	4/4

(1) Became a member of the committee on 3 August 2017. Did not attend meeting in September due to a clash with an external commitment in place prior to appointment.

- (2) Became a member of the committee on 3 August 2017
- (3) Became a member of the committee on 3 August 2017
- (4) Stood down from the Board with effect from 1 January 2018.
- (5) Stood down from the committee on 3 August 2017

Consideration of new non-executive directors

Both JCA Group and Spencer Stuart have been engaged during this year to support the search for new non-executive directors. JCA Group and Spencer Stuart do not provide search services to any other part of RBS. During 2017, the Committee considered a number of potential candidates. In April 2017, June 2017 and January 2018 respectively, Mark Seligman, Yasmin Jetha and Dr Lena Wilson, were appointed to the Board as non-executive directors.

Tenure of non-executive directors

The tenure of non-executive directors is set out below.

	Attended/ scheduled
0 3 years	46%
3 6 years	18%
6+ years	36%
	100%

Report of the Group Nominations and Governance Committee

Board and Committee membership

As previously mentioned, Mark Seligman joined the board as a non-executive director on 1 April 2017 and was subsequently appointed to the Group Nominations and Governance Committee on 3 August 2017. Mark brings broad financial services knowledge to the Board, having substantial FTSE 100 Board experience gained in various industry sectors. Mark assumed the role of Senior Independent Director with effect from 1 January 2018. Yasmin Jetha joined the Board as a non-executive director on 21 June 2017 and was subsequently appointed to the Sustainable Banking Committee on 3 August 2017 and the Technology and Innovation Committee on 1 September 2017. Yasmin brings a fresh skillset to the Board from her career as a Chief Information Officer in the consumer and media sectors coupled with extensive experience in financial services. Dr Lena Wilson was appointed to the Board as a non-executive director on 1 January 2018. Lena brings strong commercial and public sector experience to the Board, having previously served as Chief Executive of Scottish Enterprise and Senior Investment Advisor to The World Bank.

Performance evaluation

The annual review of the effectiveness of the Board and its senior Committees, including the Group Nominations and Governance Committee, was conducted internally in 2017. The Committee has considered and discussed the outcomes of the evaluation and accepts the findings. Overall the review concluded that the Group Nominations and Governance Committee operated effectively. However, certain recommendations for action were recognised including the need to: regularly engage with the external search firm to provide clarity and guidance on RBS's expectations of information to be provided to the Committee; and rebalance the agenda of the Committee to ensure greater focus on strategic issues, including director performance and board and senior management succession.

The outcomes of the evaluation have been reported to the Board and the Committee will track progress during the year.

Boardroom diversity and inclusion

RBS values and promotes inclusion in all areas of recruitment and employment. We're proud to be building an inclusive bank. The Board understands the need for a diverse mix of talented directors to effective decision-making.

Boardroom Inclusion Policy

The Board approved a revised Boardroom Inclusion Policy in February 2018 which reflects the most recent industry targets and is aligned to the RBS Inclusion Policy and Principles applying to the wider bank. This Policy provides a framework to ensure that the Board attracts, motivates and retains the best talent and avoids limiting potential caused by bias, prejudice or discrimination. The Boardroom Inclusion Policy currently applies to the most senior RBS boards: The Royal Bank of Scotland Group plc, The Royal Bank of Scotland plc, National Westminster Bank Plc and Ulster Bank Limited. A copy of the Boardroom Inclusion Policy is available on [rbs.com/about us](http://rbs.com/about-us).

Objectives and targets

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The Boardroom Inclusion Policy contains a number of measurable objectives, targets and ambitions reflecting the Board's ongoing commitment to inclusion progress.

The Policy's objectives exist to ensure that the Board, and any Committee to which it delegates nominations responsibilities, follows an inclusive process when making nomination decisions. That includes ensuring that the nomination process is based on the principles of fairness, respect and inclusion, that all nominations and appointments are made on the basis of individual competence, skills and expertise measured against identified objective criteria and that searches for Board candidates are conducted with due regard to the benefits of diversity and inclusion.

Targets and ambitions

The Board aims to meet the highest industry standards and recommendations wherever possible. This includes, but is not limited to, aspiring to meet the targets set by the Hampton-Alexander Report: FTSE100 Women Leaders (33% female representation on the board) and the Parker Report: Beyond 1 by 21 (at least one director from an ethnic minority background on the board) by the recommended target dates, 2020/2021. The policy supports our bank-wide ambition to aim for a 50/50 gender balance across all levels of the organisation by 2030.

Monitoring and reporting

The Board currently meets the Parker target and, following the appointment of Dr Lena Wilson on 1 January 2018, now meets the Hampton-Alexander target with female representation on the Board reaching 36%. The Board's composition as at 31 December 2017 against the stated targets is set out below:

	2017
Female	29%
Male	71%
	100%
Ethnic minority background	1
Non-ethnic minority background	13
	14

Inclusion and diversity progress, including information about the appointment process, will continue to be reported in the Group Nominations and Governance Committee's report in the RBS Annual Report. The balance of skills, experience, independence, knowledge and diversity on the Board, and how the Board operates together as a unit is reviewed annually as part of the Board evaluation. Where appropriate, findings from the evaluation will be considered in the search, nomination and appointment process.

Further details on RBS's approach to diversity can be found on pages 110 and 111.

Howard Davies

Chairman of the Group Nominations and Governance Committee

22 February 2018

Report of the Group Audit Committee

Letter from Brendan Nelson,

Chairman of the Group Audit Committee

Our primary focus is the integrity and quality of RBS's financial statements

Dear Shareholder,

The Group Audit Committee (GAC) has responsibility for monitoring and reviewing RBS's financial reports and disclosures, its accounting policies and practices and standards of internal control. This report provides an overview of the issues considered and debated by the GAC during 2017 and our expected priorities for 2018.

Accounting and financial reporting

The GAC's primary focus is the integrity and quality of RBS's financial statements, comprising quarterly, interim and full year results announcements and supporting documentation, in addition to the 2017 annual report and accounts.

Throughout 2017 the GAC received detailed reports from management on the key assumptions and judgements underpinning RBS's financial results. The GAC also received quarterly reports from both the internal and external auditors. The GAC provided robust challenge and detailed feedback on the financial results and in my role as Chairman of the GAC I reported to the Board on the GAC's discussions. On behalf of the GAC, I also confirmed the GAC's recommendation of the financial results to the Board for approval.

RBS resolved a number of significant legacy issues during 2017, in particular the settlement of the UK shareholder litigation and the US Federal Housing Finance Agency litigation and reaching agreement with the EC and HMT regarding the bank's remaining state aid obligations. The GAC

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was closely engaged on all of these issues in order to ensure they were appropriately disclosed and provided for.

The GAC also reviewed judgements in relation to asset and credit impairments. The value of goodwill, deferred tax and RBS's investments in subsidiaries were all key areas of focus during 2017 and the impact of macro economic risks, including developments in relation to Brexit, on the credit environment was a discussion topic throughout the year.

The GAC invested considerable time during 2017 reviewing and discussing the key assumptions, judgements and processes behind RBS's IFRS 9 calculations, in anticipation of the accounting standard coming into effect on 1 January 2018. Significant work undertaken by management, together with close scrutiny from the GAC allowed RBS to disclose the estimated impact of IFRS 9 in its H1 2017 interim results announcement.

In H2 2017 we then provided guidance on the drafting of the IFRS 9 Transition Report, which is published alongside this report, and explains the pillars of IFRS 9 compared with IAS 39 and the updated impact on RBS.

The ring-fencing programme was a crucial work stream for the bank in 2017 and, in Q3, the GAC considered the basis of preparation of the financial information included within the Ring-fencing Transfer Scheme that was ultimately presented to Court and recommended this to the Board for approval. The GAC kept existing provisions for liabilities such as those in relation to PPI and GRG under close review throughout the year to ensure that they continued to be appropriate. Additional litigation and conduct charges were taken in Q4 2017 in relation to PPI, UBI DAC customer redress and RMBS (US residential mortgage-backed securities matters) with oversight from the GAC. We also considered the suitability of significant loan impairment charges in Q3 and Q4 2017 and a revised strategy for Non-Performing Lending Assets in UBI DAC.

Systems of internal control

RBS made substantial progress in improving its control environment during 2017. The GAC, in conjunction with the Board Risk Committee (BRC), oversees RBS's control environment. In particular, we monitor the systems of internal control relating to financial management, financial reporting and accounting issues. During the year we received bi-annual updates on the control environment certification process, quarterly reports on internal controls over financial reporting plus updates from the internal and external auditors on the control environment. Most areas of the bank succeeded in obtaining an improved control environment rating by the year end and the GAC will continue to oversee this work over the coming months.

In order to support a robust control environment and to ensure that RBS promotes a culture of doing the right thing, an effective and accessible whistleblowing process is vital. RBS has whistleblowing procedures in place and the GAC receives regular updates on the whistleblowing framework. As GAC chair, I act as RBS's whistleblowing champion and met regularly with the whistleblowing team to discuss developments, trends and proposed changes to RBS's whistleblowing framework. In March 2017, I issued a communication to all staff emphasising the importance of this process and encouraging staff to participate. An audit of the bank's internal whistleblowing service was completed during the year which concluded that the process is well controlled.

External audit

Having completed their first year as RBS's external auditors in 2016, Ernst & Young LLP (EY) have continued to build and embed their knowledge of the bank during 2017. EY attended each meeting of the GAC in 2017, providing quarterly audit reports and updates on various other bespoke topics. EY's input has been invaluable in assisting the GAC's deliberations throughout 2017 and the year-end audit period and I would like to thank them for their contributions.

Report of the Group Audit Committee

Key priorities for 2018

Looking forward to 2018, the GAC will continue to ensure the integrity of the financial statements of both RBS and its subsidiaries. The changes that will be introduced to reporting structures as a result of the ring-fencing programme will be a key focus and we will continue to monitor the impact of the economic environment on RBS's credit portfolio and financial results. The GAC will also review Internal Audit's validation of control environment ratings and will strive to ensure that recent improvements in the control environment are sustained.

As ever, I would like to thank all GAC members and attendees for their continued support and dedication during 2017, in particular Sandy Crombie who stepped down from the Board at the end of the year. I would personally like to thank Sandy for his extremely valuable contribution to the work of the GAC over the years.

Brendan Nelson

Chairman of the Group Audit Committee

22 February 2018

Report of the Group Audit Committee

Report of the Group Audit Committee

Membership

The Group Audit Committee is comprised of independent non-executive directors.

	Attended/ scheduled
Brendan Nelson (Chairman)	7/7
Morten Friis	7/7
Baroness Noakes	7/7
Former Member	
Sandy Crombie	7/7

John Hughes was also a member of the GAC during his tenure as a director from 21 June until 1 September 2017. During this period John Hughes attended one scheduled meeting of the GAC. Sandy Crombie stepped down from the Committee with effect from 1 January 2018.

Brendan Nelson, Morten Friis and Baroness Noakes are also members of the BRC. Sandy Crombie was Chairman of the Group Performance and Remuneration Committee throughout 2017. Brendan Nelson and Sandy Crombie were also members of the Group Nominations and Governance Committee. Baroness Noakes was also appointed as a member of the Group Nominations and Governance Committee with effect from 1 September 2017. This cross committee membership helps facilitate effective governance across all finance, risk and compensation issues. It also helps to ensure that agendas are aligned and that overlap of responsibilities is avoided where possible.

The members of GAC are selected with a view to the expertise and experience of the GAC as a whole and with proper regard for the key issues and challenges facing RBS.

The Board is satisfied that all GAC members have recent and relevant financial experience and that each member of the GAC is independent as defined in the SEC rules under the US Securities Exchange Act of 1934 (the Exchange Act) and related guidance. The Board has further determined that Brendan Nelson, Committee Chairman, and Baroness Noakes are both financial experts for the purposes of compliance with the Exchange Act Rules and the requirements of the New York Stock Exchange, and that they have competence in accounting and auditing as required under the Disclosure Guidance and Transparency Rules. Full biographical details of GAC members are set out on pages 51 to 56.

During 2017 GAC meetings were attended by: the Group Chairman; the Chief Executive; the Chief Financial Officer; the Deputy Chief Financial Officer; the Chief Accountant; the Chief Legal Officer and General Counsel; and the Internal and External Auditors. Other executives, subject matter

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experts and external advisers were also invited to attend, as required, to present and advise on reports commissioned by the GAC. The GAC also met privately with the external auditors and separately with Internal Audit management.

Purpose of the Group Audit Committee

The GAC's responsibilities are set out in more detail in its terms of reference which are reviewed annually by the Committee and approved by the Board. These are available on: rbs.com.

Meetings and visits

The GAC held seven scheduled meetings during 2017, four of which were held shortly in advance of submission of the quarterly financial statements to the Board.

During 2017, in conjunction with members of the BRC, members of the GAC took part in an annual programme of visits to businesses and control functions in order to gain a deeper understanding of the risks and issues they face. This programme comprised:

- two visits to Risk, Conduct and Restructuring;
- two visits to Internal Audit;
- a visit to each of Services CAO and Services COO;
- a visit to Commercial & Private Banking;
- a visit to NatWest Markets; and
- a visit to Finance.

In addition to these business and functional visits, the GAC and BRC also undertook a teach-in session on IFRS 9 and visited the bank's operations in Poland. During the visit to Poland the GAC and BRC received updates on the control environment in the Global Hub Europe, met with key leaders and talent and with the external audit team in Poland.

Allocation of Group Audit Committee agenda time during 2017 was as follows:

Financial affairs of the group	42%
Standards of internal control	19%
Internal audit	18%
External audit	13%
Regulatory relationships and compliance	4%
Governance and procedural	4%
Total	100%

Performance evaluation

The performance of the GAC is evaluated annually, and at least once every three years is facilitated by an external party. Following an externally facilitated evaluation in 2015, the evaluation of the GAC's performance in 2017 was conducted internally. The evaluation process involved the completion of questionnaires by both GAC members and members of management and follow up interviews to discuss the findings.

The Board and the GAC have considered and discussed the outcomes of this evaluation. Overall the evaluation concluded that the GAC operated effectively during 2017. A small number of recommendations for improvement were made in relation to the length and timeliness of Committee papers, the length of meetings and the schedule of visits, which were approved by the GAC and the Board. Progress against these actions will be tracked in 2018 and reported back to the GAC and the Board.

The GAC conducts an annual evaluation of both the external auditor and the Internal Audit function each year. The 2017 evaluations found that EY were performing the audit of RBS effectively and that Internal Audit continued to operate effectively during the year. Further details are provided in the report below.

Report of the Group Audit Committee

Matters considered by the Committee in 2017

Key area	Matters considered and action taken by the Committee
<p>Accounting and financial reporting</p> <p>Accounting judgements and reporting issues considered in the preparation of financial reports</p>	<p>The Group Audit Committee focused on a number of salient judgements and reporting issues in the preparation of the financial results throughout 2017, including the quarterly, half year and full year results and the Annual Report and Accounts. In particular, the Committee considered, discussed and, where appropriate, challenged:</p> <ul style="list-style-type: none"> • provisions and disclosures relating to ongoing regulatory, litigation and conduct issues including: US RMBS investigations and litigation; the UK shareholder action; Payment Protection Insurance claims including whether changes were required as a result of FCA advertising campaigns; the FCA's investigation into RBS' former Global Restructuring Group; and the CBI's review of Irish Tracker mortgages. During 2017 RBS has recognised £1.3 billion of litigation and conduct provisions; • the adequacy of loan impairment provisions, focusing in particular on judgements and methodology applied to provisions. The Committee was satisfied that the overall loan impairment provisions and underlying assumptions and methodologies were reasonable and applied consistently; • the key judgements made in interpreting IFRS 9, the key features of the IFRS 9 impairment process and the impact of IFRS 9 on the bank's financial results, capital, stress testing and earnings volatility together with the IFRS 9 Transition Report, which is published alongside this report; • valuation methodologies and assumptions for financial instruments carried at fair value including RBS's credit market exposures and own liabilities assessed at fair value; • judgements made by management in relation to the carrying value of intangible assets including in particular goodwill, and RBS's investment in subsidiaries within the stand-alone parent company accounts. • management's assessment of the adequacy of internal controls over financial reporting, and identified deficiencies. The GAC noted significant deficiencies in relation to user-access to the general ledger system and the process around provisions for restructuring costs and action is being taken by management to improve these processes. There were no Material Weaknesses reported in relation to RBS Group at the year-end; • the quality and transparency of financial and risk disclosures;

	<ul style="list-style-type: none"> • the viability statement in the 2017 report and accounts and the going concern basis of accounting including consideration of evidence of RBS's capital, liquidity and funding position. The GAC considered the process to support the assessment of principal risks; assessed the company's prospects in the light of its current position and the identified principal risks; challenged the evidence to support some of the statements made; and reviewed the disclosure on behalf of the Board. The GAC supported the viability statement and the directors' going concern conclusion. (Refer to the Report of the Directors for further information); and • the comprehensive review process which supports the GAC and the Board in reaching the conclusion that the disclosures in the annual report and accounts, taken as a whole, are fair, balanced and understandable and provided the information necessary for shareholders to assess the company's position and performance, business model and strategy. The review process included: central co-ordination of the annual report and accounts by the Finance function with guidance on requirements being provided to individual contributors; review of the annual report and accounts by the Executive Disclosure Committee prior to consideration by the GAC; and a management certification process which required members of the Executive Committee and other senior executives to provide confirmation following their review of the annual report and accounts that they considered them to be fair, balanced and understandable. This process was also undertaken in respect of the half year and quarterly results announcements. The External Auditor also considered the fair balanced and understandable statement as part of the audit process. <p>Having considered the above, the Committee recommended the quarterly, interim and full year results announcements and the Annual Report and Accounts, together with supporting documentation (including Pillar 3 reports, financial supplements and investor presentations) to the Board for approval.</p>
Ring-fencing	<p>In Q3 2017, the Committee considered the basis of preparation and governance of the pro forma financial information, including the adjustments made, and forecast information that was included within the Ring-fencing Transfer Scheme and recommended this to the Board for approval.</p>

Report of the Group Audit Committee

Key area	Matters considered and action taken by the Committee
Systems of internal control	
Annual Risk and Control report	Considered the effectiveness of RBS' s internal control system, including any significant failings or weaknesses. The GAC also considered RBS' s disclosure on internal control matters in conjunction with the related guidance from the Financial Reporting Council subsequent to review by the Board Risk Committee.
Control Environment Certification	Considered the outputs of bi-annual self-assessments of the robustness of the internal control environment for RBS' s customer-facing businesses, and its support and control functions. This informs the control environment disclosure in the annual report and accounts. Most areas reported an improved Control Environment Certification rating by the year end and the remaining areas are expected to report an improved rating during 2018. Management' s plans to address certain control issues are covered in more detail in the report of the Board Risk Committee on page 75.
Three lines of Defence	Received a report on RBS' s three lines of defence model, including accountabilities under each of the lines of defence, the impact of ring-fencing governance and actions taken to improve the understanding and effectiveness of the model across RBS.
Whistleblowing	<p>Received updates on whistleblowing activity and the performance of RBS' s whistleblowing service, monitored the effectiveness of the whistleblowing framework and enquired as to any trends or themes. Also received updates on communications and awareness activity relating to whistleblowing and testing of the framework.</p> <p>The GAC Chairman acts as RBS' s Whistleblowing Champion, in line with PRA and FCA regulations. This role carries the responsibility for ensuring and overseeing the integrity, independence and effectiveness of the firm' s whistleblowing arrangements. As part of this role the GAC Chairman meets regularly with the internal whistleblowing team. During 2017 he also met with RBS' s external whistleblowing supplier and with the internal resourcing team responsible for the RBS' s relationship with that external supplier. An audit of RBS' s internal whistleblowing service was completed during the year by Internal Audit which concluded that the process is well controlled and that management understand the risks they need to manage. A small number of improvements were also recommended and management has committed to address these by 31 October 2018.</p>
Complaints	Updates were provided to the GAC on customer complaints, including the complaints process, compliance with complaints policy and any emerging themes. The GAC is focused in particular on complaints relating to accounting, internal accounting controls or auditing matters; or submitted directly to the Chief Executive Officer, his executive team, or the Chairman.
Ledger Transformation Programme	Received updates in relation to the delivery of RBS' s new general ledger which was implemented in August 2017. The new ledger replaces previous legacy systems and supports new functionality such as discrete legal entity views and multi-currency accounting on a single ledger platform. The implementation of the new ledger was an important step in improving the Finance function' s control environment.
Taxation	Reviewed RBS' s tax position, including a deep dive in October 2017 which covered: UK corporate tax compliance; tax provisions; the status of RBS' s relationship with HMRC; deferred tax assets; the RBS Tax operating model; and external tax developments including making tax digital.
Legal Reports	Considered quarterly reports on the most significant legal risks and developments affecting RBS, including the status of ongoing major litigation and investigations, privacy issues and relevant legislative and regulatory changes.
Notifiable Event Process	Received bi-annual reports on control breaches which are captured by RBS' notifiable event process. Under this process all Board directors were alerted to the most significant

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Sarbanes-Oxley Act of 2002	<p>breaches.</p> <p>Considered RBS's compliance with the requirements of the Sarbanes-Oxley Act of 2002, and was satisfied in this respect. The GAC noted Significant Deficiencies in relation to user-access to the general ledger system and the processes around provisions for restructuring costs and action being taken by management to improve these processes. Remediation of a significant deficiency previously identified in relation to its subsidiary, NatWest Bank, in connection with legal entity recharge accounting was monitored during 2017 and downgraded in December 2017. No Material Weaknesses were reported in RBS Group at the year-end. Provided oversight of the drive to continue to improve SOX processes and received a number of updates in this regard.</p>
<p>Internal audit</p>	
Reports and Opinions	<p>Received quarterly reports and opinions from Internal Audit throughout 2017. These reports and opinions updated the GAC on Internal Audit's view of the progress made in improving RBS's risk and control environment and risk and control awareness by reference to the relevant ratings for each business and function, and the risks which may impact the bank achieving its targets. Internal Audit also provided updates on the audit plan and any anticipated changes to the plan and outlined material and emerging concerns identified through their audit work. In addition, Internal Audit reported on items including: Pillar 3 reporting; RBS's Global Systemically Important Bank status; and the whistleblowing process.</p>

Report of the Group Audit Committee

Key area	Matters considered and action taken by the Committee
Internal audit continued	
Annual Plan and Budget	Considered and approved Internal Audit's plan for 2017, which is focussed on RBS's highest risks. An interim update on performance against the plan was provided to GAC at the end of H1 2017. The GAC also considered Internal Audit's budget and was satisfied that this was sufficient to allow Internal Audit to deliver the plan.
Internal Audit Charter and Independence	Updates to Internal Audit's charter were approved by GAC. The updates aligned the charter with the language of the October 2016 revisions to the Institute of Internal Auditors International Professional Practice Framework and the latest version of Internal Auditor's methodology, which was updated in April 2017. The GAC also confirmed the independence of Internal Audit.
Visits	During two visits to Internal Audit in 2017, the GAC received updates on a variety of issues impacting the Internal Audit function, including: resourcing; bench strength; succession planning; quality assurance; strategic priorities; changes to the function's structure and opinion approach in anticipation of ring-fencing; and the 2018 Audit Plan.
Chief Audit Executive	The Chief Audit Executive continued to report to the Chairman of the GAC, with a secondary reporting line to the Chief Executive for administrative purposes. The GAC assessed the annual performance (including risk performance) of the Chief Audit Executive.
Annual Evaluation	The annual review of the effectiveness of Internal Audit was undertaken internally in 2017. Feedback on Internal Audit was provided by GAC members and attendees (including the external auditors), chairmen of subsidiary audit committees, key members of franchise and function risk committees and other key members of management. The evaluation concluded that Internal Audit had operated effectively during the year. Certain recommendations were made to aid continuous improvement within the function including continuing to bolster succession planning and bench strength, increasing connectivity between Internal Audit teams and sharing best practice. These recommendations will be implemented during 2018 and progress will be tracked by the GAC.
Relationship with regulators	
Regulatory Relationships	Received regular reports on the status of RBS's relationships with its key regulators. The GAC Chairman also attended continuous assessment meetings with the PRA and FCA, a trilateral meeting with the PRA, a meeting with the FRC as well as two meetings with UK Financial Investments Limited during 2017.
External audit	
External Audit Reports	Jonathan Bourne has been EY's lead audit partner for RBS since EY assumed the role of external auditor in March 2016. Jonathan Bourne attended each meeting of the GAC throughout 2017 and reported to the GAC each quarter on their audit work and related conclusions, including the appropriateness of judgements made by management and their compliance with international financial reporting standards.
Audit Plan and fees	Received updates in relation to the external auditor's 2017 plan and approved the 2017 audit fees including the fee for the 2017 interim results. The GAC was authorised by shareholders at the last Annual General Meeting to fix the remuneration of the external auditors.
Annual Evaluation	Conducted an internal evaluation to assess the independence and objectivity of the External Auditor and the effectiveness of the audit process during 2017. Questionnaires were issued to the GAC members, attendees, the Finance Officers of the Franchises and Functions and key members of the Finance team. The evaluation assessed in particular the external auditor's mindset and culture, skills, character and knowledge, quality control and judgement. The evaluation highlighted that the objectivity, independence and integrity of the lead audit partner and the audit team is highly rated by both the GAC and management and concluded that the external auditor was operating effectively. A small

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	<p>number of recommendations for continuous improvement were identified including enhancements to reporting; adding value by analysis and suggested management actions; and the pre-planning of audits which will be reviewed by the external auditor. Following the evaluation the GAC recommended that the Board seek the reappointment of EY as external auditor at the next annual general meeting.</p>
CASS Opinions	<p>The external auditor presented the results of its assurance procedures on compliance with the FCA's Client Asset Rules for RBS regulated legal entities for the year ended 31 December 2016. The GAC also considered the CASS Audit plan for 2018, the findings of which will be reported to the GAC once the audit is complete.</p>
External Audit Report to the PRA	<p>The GAC considered EY's 2016 report to the PRA under supervisory statement SS1/16 which set out the PRA's expectation for auditors to provide written reports to the PRA concerning the audits of major banks and building societies, as set out in chapter 8 of the Auditors Part of the PRA rulebook. The report responded to specific questions posed by the PRA relating broadly to credit impairment, hedge accounting, trading/valuation, forecasting and conduct. GAC also discussed the questions received from the PRA in relation to the report required for 2017.</p>
Independence of the previous external auditor	<p>As RBS's previous external auditor, Deloitte LLP (Deloitte) have an ongoing role to consent to the release of their prior period audit opinions for US reporting purposes, the GAC considered the processes and procedures whereby Deloitte were able to re-establish their independence in order to do so.</p>

Report of the Group Audit Committee

Key area	Matters considered and action taken by the Committee
Audit and non-audit services	
Non-audit service policy	<p>In order to comply with the Sarbanes-Oxley Act of 2002 and the EU Audit Regulation, RBS has a policy in place in relation to the engagement of the external auditors to perform audit and non-audit services (the policy). The GAC reviews the policy at least annually to ensure it remains fit for purpose. In accordance with the policy, all audit services and permitted non-audit services must be approved before the engagement commences.</p> <p>Under the policy certain services are classed as Audit-Related Services and these may be approved by the Deputy Chief Financial Officer, on behalf of the GAC, up to a limit of £100,000 each financial quarter. Engagements for Audit-Related Services in excess of this quarterly limit require the approval of the GAC Chairman. All Audit-Related Services are reported to the GAC quarterly. The GAC has also delegated authority to the Deputy Chief Financial Officer to approve the provision of services by the external auditor to non-consolidated subsidiaries of RBS within an annual cap and to approve engagements with the external auditor where RBS has limited or no influence in the selection process. All such engagements are reported to the GAC each quarter.</p> <p>For all other permitted non-audit service engagements, where the fee is below £5,000 approval by the Deputy Chief Financial Officer is required. Where the fee is above £5,000 but below £100,000 approval by the GAC Chairman is required. For engagements where the fee is expected to exceed £100,000 a competitive tender process must be held and approval of the full GAC is required. In addition all engagements must be approved by the Deputy Chief Financial Officer and by Supply Chain Services. All such ad hoc approvals of non-audit services are ratified by the GAC each quarter.</p> <p>During 2017, the external auditors were approved under the policy to undertake the following significant engagements:</p> <ul style="list-style-type: none"> • to carry out (i) a review of RBS's OFAC compliance policies and procedures and their implementation for RBS's global business lines; and (ii) appropriate risk focussed sampling of U.S. dollar payments, as required in connection with the 2013 Cease and Desist Order issued to RBS by the Board of Governors of the Federal Reserve; • the annual client money (CASS) audit as required by the FCA; • the annual audit of the bank's LIBOR submissions as agreed with the US Commodity Futures Trading Commission and the FCA; • the audit of note issuance in Scotland and Northern Ireland and in respect of notes in circulation as requested by the Bank of England;

- work in respect of reporting for RBS NV in respect of COREP and FINREP returns performed over and above normal regulatory reporting;
- reporting to the PRA on matters related to the audit;
- the sustainability audit; and
- overseas regulatory reporting.

The decision to approve the engagement of the external auditor for the services noted above was due to factors including synergies and efficiencies relating to the audit work, their existing knowledge of RBS which allowed work to commence quickly and with minimal disruption and the benefits in maintaining consistency between similar engagements. In each case the GAC was satisfied that the engagement did not impact the external auditor's independence. The total value of non-audit services fees during the year was 15.1% of the audit fee.

The policy also includes certain safeguards in relation to engagements with RBS's previous external auditor, Deloitte who have an ongoing role to consent to the release of their prior period audit opinions for US reporting purposes and may therefore require to re-establish their independence. During 2017 Deloitte were approved under the policy to carry out the following significant engagements:

- setting of a framework for documentation review to be undertaken in connection with an attestation made to the National Futures Association in relation to record keeping and reporting;
- provision of financial advice in relation to the disposal of a business in which RBS held a shareholding;

Report of the Group Audit Committee

Key area	Matters considered and action taken by the Committee
<p>Audit and non-audit services continued</p>	<ul style="list-style-type: none"> • an independent review of UBI DAC compliance with the Code of Conduct Mortgage Arrears requested by the Central Bank of Ireland; • provision of resource support to help support RBS's Technology teams with understanding and implementing an end to end technology delivery framework and embed these new ways of working within Technology teams; • review of the financial position of a customer to allow Senior Lenders, including RBS, to work with the customer on a medium term restructuring solution; • support to the businesses and Finance Central SOX team in documenting the end to end processes underlying statutory financial reporting, confirming the associated risk and mitigating suite of SOX controls ; • to build an iOS application for an Entrepreneurial Spark concept; • quality assurance services for RBS's customer due diligence remediation programme; • development of an initial proposition and development roadmap for a new digital platform that will enable us to launch, test and refine innovative offerings for both customers and non-customers; • development of a risk assessment process, control framework and review framework in relation to new corporate tax offences under the Criminal Finances Act; • as the skilled person to continue to support the Bank's ring-fencing programme under ICB; and • to support the Bank in implementing new technologies to create excellent customer experiences, contribute to a strong cost:income ratio and simplify business processes. <p>Further details of the non-audit services that are prohibited and permitted under the policy can be found on rbs.com. Information on fees paid in respect of audit and non-audit services carried out by the External Auditor can be found in Note 5 on the consolidated accounts.</p>

Brendan Nelson
Chairman of the Group Audit Committee

Report of the Board Risk Committee

Letter from Baroness Noakes

Chairman of the Board Risk Committee

A key part of RBS becoming a simpler, safer and customer focused bank is excellent risk management

Dear Shareholder,

A key part of RBS becoming a simpler, safer and customer focused bank is excellent risk management. The Board Risk Committee (BRC) plays an important role in overseeing how well RBS manages its risks. The purpose of this report is to describe how the BRC discharged this responsibility during 2017.

2017 has been another busy year for the BRC and our detailed report, which follows, sets out the detail of what we have done. I would like to focus on two key areas, both of which are driven by regulatory requirements.

Ring-fencing and Resolution

RBS, in common with other large banks, is required to deliver both ring-fencing and key parts of its resolution plans by the beginning of 2019.

The separation of our core UK and European banking business from activities that are required to be outside the ring-fence involves many complex activities including: legal restructuring of the RBS group; detailed analysis and transfer arrangements for individual customers and products; and changes to the way in which we manage the business.

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In parallel with this RBS needs to have plans acceptable to the regulators which allow RBS to be dealt with effectively in the event of financial failure. An important part of this is Operational Continuity in Resolution (OCIR) which is aimed at ensuring that the ring-fence bank has all the systems and resources it needs to operate. This in turn requires much more formality and structure around the way that individual parts of RBS trade with each other through inter-group agreements and these agreements are a key part of how we deliver ring-fencing as well.

The BRC has responsibility for overseeing the delivery of these programmes and the management of the associated execution and delivery risks on behalf of the Board. We reviewed the ring-fencing programme at every meeting and receive reports from an integrated assurance programme. In H2 2017, the BRC supported the incorporation of OCIR requirements within the ring-fencing programme in recognition of the interdependencies. We will monitor closely the delivery of the residual elements of RBS's Resolution Planning separately.

Capital and Liquidity

Capital and liquidity are important areas for risk management in any bank and the regulatory requirements are intensifying, particularly in the context of ring-fencing.

The Committee devoted considerable time this year to stress testing. The 2017 Bank of England exercise incorporated a requirement to undertake two stress scenarios (an Annual Cyclical Scenario (ACS) and a Biennial Exploratory Scenario (BES)) followed by a further two IFRS 9 exercises on non-credit card and credit card exposures. The BRC reviewed the various components and stages of these exercises and recommended that the Board approve them.

We also conducted detailed reviews of the Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP) returns for the Group. In preparation for ring-fencing, the Committee also oversaw the preparation of an ICAAP for the future ring-fenced bank and both an ICAAP and ILAAP for RBS's future NatWest Markets subsidiary which will sit outside the ring-fence.

Other Work

Our detailed report sets out what we have done in other areas during the year. The more material areas have been:

- **Risk appetite:** we continued the work of earlier years to oversee the extension and refinement of RBS's comprehensive risk appetite framework, including its cascade to our key franchises and preparation for ring-fencing.
- **Control environment:** Strengthening the control environment has been a key part of the RBS's transformation programme. Significant progress was made in almost all parts of RBS but not enough to get the overall control environment to where it needs to be.
- **Transformation programme:** we continued to oversee the complex programme of bank-wide initiatives. This includes the delivery of a number of key regulatory requirements. In recognition of the improvements made to the effectiveness of the programme, we were able to reduce our detailed involvement compared with prior years.

Key Priorities for 2018

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Successful delivery of ring-fencing and OCIR will continue to be a key focus area in 2018 given the regulatory deadline of 1 January 2019. Our focus will shift from legal compliance to ensuring that we have the right risk management and oversight processes to underpin the new structures. I expect that we will continue to focus on the control environment in particular the parts of the business which still need to improve long term sustainability.

I would like to end by extending my gratitude to my fellow Committee members and to the bank's senior leadership team for their support and dedication to the business of the Committee during 2017.

Baroness Noakes

Chairman of the Board Risk Committee

22 February 2018

Report of the Board Risk Committee

Report of the Board Risk Committee

The role and responsibilities of the Board Risk Committee

The Board Risk Committee assumes responsibility on behalf of the Board to provide oversight of current and potential risk exposures and future risk strategy, including the determination of risk appetite and tolerance, and to promote a culture of risk awareness within RBS. A large part of the Board Risk Committee's work is the review of reports and regulatory submissions on behalf of the Board and recommending them for approval. Where this is the case, the Report below is annotated with an asterix (*).

The Committee's responsibilities are set out in more detail in its terms of reference which are reviewed annually by the Committee and approved by the Board. These are available on RBS's website: rbs.com.

Membership

The Board Risk Committee is comprised of independent non-executive directors. Details of the skills and experience of each of the Committee members are set out in their biographies on pages 51 to 55.

	Attended/ scheduled
Baroness Noakes (Chairman)	9/9
Frank Dageard	9/9
Morten Friis	9/9
Penny Hughes	9/9
Brendan Nelson	9/9

Brendan Nelson is chairman of the Group Audit Committee of which Baroness Noakes and Morten Friis are also members. Penny Hughes is chairman of the Sustainable Banking Committee. This common membership across Committees helps to ensure effective governance across the committees.

Committee meetings are also attended by the RBS Chairman, relevant executives, (including the Chief Executive, Chief Financial Officer, Chief Risk Officer, Chief Conduct & Regulatory Affairs Officer, Chief Legal Officer and General Counsel and Chief Audit Executive), and the lead partner of the External Auditor. External advice is sought by the Committee, where appropriate.

Meetings and visits

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Nine scheduled meetings and six ad hoc meetings were held in 2017. The ad hoc meetings were required to consider: the results of various phases of internal and external stress tests; review of ICAAP and ILAAPs and reverse stress testing results; and the processes supporting the formal documentation required for the Ring-fencing Transfer Scheme.

In 2017, members of the Committee undertook a programme of visits to various businesses and control functions including bi-annual visits to Risk, Conduct and Restructuring function in conjunction with members of the Group Audit Committee. The purpose and scope of this programme is discussed in detail in the Report of the Group Audit Committee on page 67.

The Committee also held in-depth sessions on risk reporting and held a teach-in on both capital and IFRS 9 requirements. A no formal agenda session was held with members of the BRC to enable open discussion about the key risks and threats to the organisation independently of the issue management and procedural matters which necessarily form a material component of the BRC agenda.

Performance Evaluation

The annual review of the effectiveness of the Board and its senior Committees, including the Board Risk Committee, was conducted internally in 2017. The Committee has considered and discussed the outcomes of this evaluation and accepts the findings. Overall the review concluded that the Board Risk Committee continued to operate effectively.

However, certain recommendations for enhancing the operation of the Committee were identified, including: increased legal entity focus; devolving greater oversight to executive fora to reduce the pressure on Committee time; and further enhancement in the quality of information presented to the Committee to ensure it is concise, with key matters of judgement clearly highlighted. Recognising that RBS has now addressed several legacy issues, it was agreed that the Committee should look to re-focus to be more forward looking, and dedicate less time to remediation and operational issues.

The outcomes of the evaluation have been reported to the Board and the Committee will track progress on its 2018 priorities during the year.

Allocation of Board Risk Committee agenda time:

Current risk profile and issues	22%
Change agenda and large projects	10%
Process, policies and risk appetite	13%
Regulatory returns and stress testing	14%
Accountability and Remuneration	6%
Governance & Procedural	7%
Risk, conduct and regulatory affairs focus sessions	7%
Franchise and function focus sessions	21%
Total	100%

Report of the Board Risk Committee

Matters considered by the Committee in 2017

Key area	Matters considered and action taken by the BRC
<p>Risk Profile</p> <p>Reporting</p>	<ul style="list-style-type: none"> • The Committee provided oversight of RBS's risk profile relative to RBS's strategy and risk appetite through the review of key emerging and identified top risks impacting RBS's businesses and operations as presented in the Risk & Conduct Management Quarterly Report, and supplemented by short form reports at all other meetings. • Received verbal updates from the Chief Risk Officer at each meeting highlighting the most current and material risks impacting RBS. • A focused session on enhancement of risk reporting was held in October 2017 which resulted in a number of recommendations on content and presentation in the Risk & Conduct Management Quarterly Report. The Committee will monitor how the changes are being implemented through 2018. • Received updates from Executive Risk Forum (ERF) and Technical ERF and discussed any emerging risks and issues escalated, in particular those areas where BRC had devolved detailed oversight to those fora.
<p>External developments</p>	<ul style="list-style-type: none"> • Received reports from the Chief Risk Officer at each meeting highlighting external developments with the potential to affect the bank's ability to meet its strategic objectives or continue its operations. Particular focus was placed on political developments and stability, including Brexit preparedness and the potential impact of the UK and certain EU elections; prospective EU capital requirements; UK economic resilience - inflation, interest rates; unemployment and the level of consumer indebtedness; the UK base rate increase; and global sanctions. • BRC also received a report on new and emerging threats including established risks such as competition but also risks posed as a result of digitisation.
<p>General Counsel's report</p>	<ul style="list-style-type: none"> • The General Counsel reported to the Committee at each meeting on current and emerging key legal developments and significant litigation risks affecting the bank. RBS's plans to comply with the General Data Protection Regulation were kept under review.
<p>Regulatory Affairs and Developments</p>	<ul style="list-style-type: none"> • Introduced a new report during 2017 covering material regulatory interactions, communications and developments to ensure a stronger focus on the areas of key regulatory interest. Reviewed the governance and assurance supporting material regulatory representations and attestations and considered RBS's strategic plans against the key themes in the FCA Risk Outlook and Business Plan. • A Board Oversight Committee (BOC) has been established to oversee required enhancements to the governance and risk management practices in UBI DAC and, where appropriate, the BRC will work in conjunction with the BOC to understand implications for RBS processes.

<p>Control Environment</p>	<ul style="list-style-type: none"> • Received bi-annual reports on the control environment of the franchises and functions and monitored the route and achievability of being within appetite by end of 2017. Sought management's assurance that appropriate measures were in place to ensure that the businesses could continue to operate safely, where control weaknesses had been identified. • Particular focus has been placed on areas where the control environment requires enhancement. The BRC has devolved detailed review and challenge of management plans to remediate and strengthen the conduct and control environment across the NatWest Markets franchise to Technical ERF. We received reports on those discussions and actions being taken, paying particular attention to the robustness of issue closure and downgrade; interdependencies; and sustainability. • Technical ERF is also overseeing in detail, management's plans to return the control environment within UBIDAC to a within risk appetite position, ensuring identified best practices are applied as adopted and learned through Nat West Markets remediation. BRC will receive regular updates on those discussions through 2018. • The Committee is also monitoring closely the programme to deliver required improvements to customer due diligence processes as well as remediation work. We will review progress on a quarterly basis in 2018 given the programme's criticality to attaining a satisfactory control environment Bank-wide.
<p>Business and subsidiary risk committees</p>	<ul style="list-style-type: none"> • Received quarterly reports from the Chairman of the US Risk Committee to the point of its retirement in May 2017. The US Risk Committee was established to provide oversight of the risk management framework of RBS's combined US operations. Following closure of its Connecticut Branch, alternative governance processes, commensurate with the scale of RBS's residual US activity were established. The BRC retains oversight of key regulatory submissions. • Received quarterly reports from the chairmen of franchise risk committees and those of certain principal subsidiaries outlining risk profile relative to risk appetite and any control weaknesses and remediation plans. In 2018, this reporting mechanism will be extended to all material regulated subsidiaries.

Report of the Board Risk Committee

Key area	Matters considered and action taken by the BRC
Major Programmes	
Transformation	<ul style="list-style-type: none"> • Kept the execution risk of the bank-wide transformation programme under review receiving regular updates from the programme team on progress, including independent opinions from Risk, Conduct and Restructuring function and Internal Audit. BRC encouraged the development of a reporting dashboard to track outcomes more effectively. • Reviewed management's lessons learned from oversight of the programme in 2016 and actions being taken to address findings. • Transitioned reporting to quarterly, reflective of the progress made to clearly report and track deliverables; the improving status of the programme; and the increased alignment between management, Risk, Conduct and Restructuring function and Internal Audit. • Where underlying programmes were reported to be losing traction, BRC took specific reports on delivery. Specifically, BRC received reports on the progress of RBS to achieve Merchant compliant position under the Payment Card Industry Data Security Standard (PCI DSS) and considered challenges to delivery of the Future Clearing Model programme.
Williams & Glyn	<ul style="list-style-type: none"> • Following the announcement of the European Commission's decision to approve HMT's alternative remedy package in September 2017, the BRC considered implementation plans to establish the required schemes, including critical path dependencies/progress towards operational readiness. • Reviewed plans to reintegrate the business previously described as Williams & Glyn into RBS's retail business including controls and safeguards to ensure appropriate oversight of the portfolio and the timing of transition.
Ring-fencing	<ul style="list-style-type: none"> • Developed a programme of detailed quarterly reporting on the ring-fencing implementation programme, supplemented by shorter updates at intervening meetings given the considerable volume of activity and criticality of the deliverable. • Considered the key execution risks in the programme and oversaw key regulatory deliverables. Reviewed the Ring Fence Transfer Scheme documentation and Skilled Person Report, including the required management representation letter and regulatory attestation. The Skilled Person also attended relevant meetings to update on its findings. Latterly, the BRC supported the integration of Operational Continuity in Resolution delivery within the programme given the interdependencies with ring-fencing activity. Throughout, the Committee sought to ensure the programme remained focussed on the delivery of ring-fencing over discretionary strategic deliverables. • Received opinions from Risk, Conduct and Restructuring function and Internal Audit on progress. Oversaw the appointment of KPMG as independent third party assurance provider and received the outputs of the work undertaken. An integrated assurance approach was adopted in the period, the scope of which was reviewed by the BRC to ensure effective assurance activity across Risk, Conduct and Restructuring

	function, Internal Audit and KPMG.
Recovery and Resolution Planning	<ul style="list-style-type: none"> <li data-bbox="639 197 1497 426">• The Committee increased its oversight of Resolution Planning to quarterly and requested that this be classified as a major programme within risk reporting. This was reflective of the requirement to ensure adequate legal entity focus; pan-bank engagement; regulatory scrutiny and interdependency of elements with the ring-fencing deliverables. Latterly, the BRC supported management's decision to transfer OCIR elements to the ring-fencing programme so as to increase the pace of delivery and demonstrate congruence with ring-fencing. The Committee reviewed outputs of a third party benchmarking review of RBS's progress as compared to peers and will monitor actions being taken in response. A re-baselined plan will be reviewed in early 2018. <li data-bbox="639 470 1246 489">• Reviewed the draft 2017 Recovery Plan in June 2017.*

Report of the Board Risk Committee

Key area	Matters considered and action taken by the BRC
Enterprise Wide Risk	
Risk appetite	<ul style="list-style-type: none"> • Reviewed the risk appetite governance framework; provided feedback on the mechanism for managing and escalating breaches of risk appetite and providing oversight of the cascade of risk appetite.* • Considered an annual refresh of the Risk Appetite Framework and received an update on the guidance and support that would be provided to the business throughout 2017 to ensure that the Framework was consistently embedded across the organisation. • Following work undertaken in 2016 to transition to a position where the Board/BRC played a greater role in the approval of risk appetite for RBS's most significant risks, it was agreed that this would take place on a phased basis. The BRC reviewed qualitative risk appetite statements and certain quantitative risk appetite measures relating to Market Risk and Credit Risk, being those measures where the Board would wish to be informed if those limits were exceeded (Board Risk Measures).* • Considered a report on the approach to risk appetite under structural reform (reflecting the future legal entity status of the Group). The BRC reviewed the proposed cascade of strategic risk appetite limits for the legal entities within and outwith the future ring-fenced structure. It was noted that process and limits would continue to be refined in 2018.* • Reviewed escalated breaches of risk appetite and action being taken in response.* • Reviewed the annual refresh of risk appetite for strategic risks and made suggestions for refinements.* • Reviewed the cascade of risk appetite for strategic and material risks to franchises and functions and received a report on the alignment of risk appetite, top to bottom across the organisation. • Considered various detailed risk appetite statements and associated metrics for material risks.
Risk Culture	<ul style="list-style-type: none"> • Reviewed work being undertaken across RBS to improve risk culture including the status of the various ongoing bank-wide risk culture initiatives. Considered the outputs of a PwC review of progress in strengthening and embedding risk culture and discussed the actions identified that would have the greatest impact on risk culture. • Reviewed management's proposed framework to measure risk culture maturity against target state and considered the outcome of the assessment of progress against agreed performance criteria.
Client Pricing for Assets and Liabilities	<ul style="list-style-type: none"> • Undertook an annual review of the client pricing process against regulatory requirements to ensure that the pricing of liabilities and assets takes into account the

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	bank's business model and risk strategy.
Three Lines of Defence	<ul style="list-style-type: none"> Received an update on the work being undertaken to improve the effectiveness of the three lines of defence model within RBS, including actions being taken to improve understanding of roles and accountabilities under each of the lines of defence.
RDAR	<ul style="list-style-type: none"> Monitored progress towards full compliance with the Basel Principles on Effective Risk Data Aggregation and Reporting (RDAR) and undertook an annual review of the RDAR framework.*
Risk Assurance	<ul style="list-style-type: none"> Received quarterly reports from the Risk Assurance team, on issues highlighted by reviews conducted in each of the franchises.

Report of the Board Risk Committee

Key area	Matters considered and action taken by the BRC
Operational, Credit and Market Risk	
Credit, Market and Operational risk MI	<ul style="list-style-type: none"> Reviewed the bank's risk profile relative to credit, market and operational risk, and examined detailed management information (MI) within the quarterly Risk Management Report in this regard.
Operational Risk	<ul style="list-style-type: none"> Change capacity - Discussed the change risk profile of the bank and the prioritisation and impact of mandatory change programmes and considered opinion as to whether RBS had the required resource, processes and systems to deliver its change portfolio within agreed timescales. Reporting on change capacity has now been incorporated within routine quarterly risk reporting. Risk and Control Assessments - monitored management's progress to complete and refresh these assessments which are intended to provide an end to end perspective of the risk and control profile across the businesses. Considered scope of the exercise and impact of the outputs on risk profile. Undertook a review of the adequacy and effectiveness of the Risk Policy Framework and considered work being undertaken to reduce the volume of exceptions to policy and remediation in areas of non-compliance. Reviewed the statutory Annual Risk and Control Disclosure regarding the internal control system in RBS prior to its review by the Group Audit Committee.* Received bi-annual reports on Resilience and Security which considered in particular, Cyber Risk; internal and external fraud and records management. Considered the statement of risk appetite for operational risk together with a new suite of metrics.
Credit Risk	<ul style="list-style-type: none"> Oversaw the Executive Credit Group (ECG) receiving a summary of the decisions made by the ECG in the period. Reviewed the most material credit decisions made in 2017 and examined trends in the market. The BRC requested more data on declined requests and explanation of risk/return relative to each decision. Reviewed a revised governance framework for large credit exposure decisions, designed to enhance the level of Committee and Board oversight.* Reviewed a suite of Credit Risk Board Risk Appetite Measures.* Undertook a deep dive on the mortgage portfolio with a focus on drivers of growth and controls and received a report on Non-Performing Loans and Provision Coverage.
Market Risk	<ul style="list-style-type: none"> Held a teach-in on the impact of the Fundamental Review of the Trading Book and the impact of the new regulation. Reviewed a suite of Market Risk Board Risk Appetite Measures.*

Report of the Board Risk Committee

Key area	Matters considered and action taken by the BRC
Conduct and Financial Crime	
Financial Crime	<ul style="list-style-type: none"> • Reviewed the annual Group Money Laundering Reporting Officer's Annual Report.* • Received regular updates on financial crime risk, with a particular focus on the customer due diligence remediation programme, including scope, accountability, the timescale to return to appetite and impact on bank-wide control environment. • Considered the Financial Crime risk appetite statement and associated limits and measures.
Conduct risk	<ul style="list-style-type: none"> • Assessed progress to meet the requirements of the European Deposit Guarantee Scheme and approved the required compliance statements for submission to the PRA.* • Received a report on how RBS surveillance processes and controls operated, in particular how these benchmarked to peers, and considered required enhancements. • Received reports on Conduct Risk Appetite and performance, including action being taken to improve bank-wide conduct risk profile. • Reviewed a revised statement of risk appetite and metrics which concentrated on customer outcomes as the Committee had previously requested. • While a Board Oversight Committee (BOC) had been established to oversee required enhancements to the governance and risk management practices in UBI DAC, where appropriate, the BRC will work in conjunction with the BOC to understand the implications for RBS processes. • Reviewed reports relating to the 2015 US Cease & Desist Order. • Received an annual report on oversight of operational compliance of RBS and NatWest with FCA Client Asset Rules (CASS) and compliance with CASS resolution pack rules.*
Capital and Liquidity Risk	
Stress Testing	<ul style="list-style-type: none"> • Considered the 2017 Bank of England Stress Tests, comprising, for the first time, two stress scenarios – the Annual Cyclical Scenario (ACS) and the Biennial Exploratory Scenario (BES). The Committee reviewed the scenario expansion and expansion of market risk factors and considered key assumptions and judgements and reviewed the outputs and management actions.* • Reviewed the Bank of England IFRS 9 stress tests on non-credit card and credit card exercises including the assurance provided by Internal Audit and confirmation that management had undertaken robust review.*

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	<ul style="list-style-type: none"> • Reviewed the 2017 budget and stress test results (including IFRS 9) and 2017 ICAAP Stress Test Scenarios together with opinions from Risk and Internal Audit.* • Considered 2018 budget and stress test results including Risk and Internal Audit opinions.* • Reviewed reverse stress testing results. • Oversaw enhancements to the bank's stress testing capability, in particular the remediation actions taken in response to the PRA review of stress testing capability. Work being undertaken to strengthen and validate models and improve supporting governance was a key focus.
ICAAP and ILAAP	<ul style="list-style-type: none"> • Reviewed the RBS Group and pro forma NatWest Markets Plc ILAAP and ICAAP, with particular focus on assumptions and areas of judgement and considered associated Risk and Internal Audit opinions.* • Reviewed the NatWest Markets ILAAP and ICAAP, and accompanying Internal Audit Report.* These are the first such regulatory submissions and the documents will continue to be refined and tailored during 2018.
Other capital and liquidity coverage	<ul style="list-style-type: none"> • Reviewed the risk profile of the Treasury Function in a focus session held to understand better its position relative to risk appetite, emerging trends, threats and regulatory developments over the following year. • Considered the bank's usage of the Bank of England Term Funding Scheme, noting that the Monetary Policy Committee decision to close the drawdown period on 28 February 2018 had no material impact on the bank's funding and liquidity plans. • Considered conduct liquidity stress scenario analysis in detail. • Undertook a teach-in on capital with a focus on legal entities (including the operation of external and internal MREL), future RWA developments and capital headwinds (Basel 3 amendments, PRA mortgage floors, IFRS 16). • Reviewed pension strategy and oversaw interactions with the Pension Trustees.

Report of the Board Risk Committee

Key area	Matters considered and action taken by the BRC
Accountability and Remuneration	
Accountability and Remuneration	<p>Continued to provide oversight over the risk dimension of performance and remuneration arrangements, working closely with the Group Performance and Remuneration Committee. The Report of the Group Performance and Remuneration Committee on pages 83 to 105 includes further detail on how risk is taken into account in remuneration decisions. Key matters considered by the Committee included:</p> <ul style="list-style-type: none"> • accountability recommendations in respect of significant material events and high earners; • the risk and control objectives of members and attendees of the bank's Executive Committee, with additional focus on underlying objectives for the Chief Risk Officer; • an assessment of the risk/conduct performance of members and attendees of the Bank's Executive Committee, with recommendations made to the Group Performance and Remuneration Committee as appropriate to inform its decision on pay and awards; • an assessment of the risk/conduct performance of the Bank and its businesses, with recommendations made to the Group Performance and Remuneration Committee to inform its decision on adjustments to the annual bonus pools; • performance conditions for the bank's Long Term Incentive Plans and assessment of proposed vesting levels to ensure risk management/conduct performance is fairly reflected in vesting outcomes; and • the proposed Executive Director Future Remuneration Policy as detailed on pages 87 to 88 from a risk and control perspective.

* Items that were reviewed by BRC prior to recommendation to the Board

Baroness Noakes
Chairman of the Board Risk Committee

Report of the Sustainable Banking Committee

Letter from Penny Hughes

Chairman of the Sustainable Banking Committee

We remain committed to building a sustainable bank that is great for our stakeholders.

Dear Shareholder,

I am pleased to report on the progress made by the Sustainable Banking Committee (SBC) during another busy year for RBS.

The Committee has retained its forward looking, strategic outlook focusing on its five priority areas: culture; customers; people; brand & communications; and environmental, social and ethical (ESE) issues.

The Sustainable Banking Committee plays an important role on behalf of the Board in considering the long term challenges RBS will face, and how we can be proactive in tackling those as well as meeting our ambition for customers. With this remit, the areas the Committee focused its efforts on during 2017 were:

- technology and open banking;
- building a healthy culture;
- challenging management on progress towards reaching number one for customer service, trust and advocacy; and
- converting doing the right thing into good customer outcomes.

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We have made good progress this year and below are some of the highlights of our achievements:

- an enhanced stakeholder engagement programme;
- a dedicated session on Personal & Business Banking s plan to improve Net Promoter Scores and reduce complaints;
- continuing the integration of sustainable banking into our core businesses and enhancing disclosure of integrated reporting elements in the Strategic Report;
- supporting and challenging management to make tangible progress on culture;
- development of a sustainable banking dashboard to provide the Committee with a consolidated view on RBS s performance in respect of key priorities such as the customer, culture and our reputation, to monitor progress against becoming a truly sustainable bank;
- supporting management in setting more ambitious environmental targets given the excellent progress RBS made in respect of previous targets set on carbon, paper and water;
- encouraging management to consider and understand external benchmarks, surveys and ratings and the insights those provide in terms of RBS s reputation and experience for customers;
- a focus on people, with the Committee holding a spotlight session on the wellbeing agenda, being engaged on our inclusion strategy and the employee value proposition; and
- being consulted on the Modern Slavery Act statement prior to it being published for the first time last year.

In August 2017 we were delighted to welcome Yasmin Jetha as a member of the Committee. Yasmin brings a fresh perspective and enthusiasm for the work that we do. In January 2018 we then welcomed Dr Lena Wilson as a member and with her strong public sector and commercial background is a valuable addition to the Committee.

The efforts to build a responsible and sustainable business are recognised through independent and external measures. Some examples include:

Culture

- Our own measurement surveys correlate with the progress being recognised by the Banking Standards Board culture assessment. We need to maintain momentum and be diligent in identifying and taking action in weaker areas.

Customers

- With clearer customer segmentation in place, good progress is being made in meeting the needs and expectations of NatWest and RBS Premier customers and those customers looking to buy a home. The significant trend to online is supported by our leading mobile app and digital banking propositions for business and commercial customers.

People

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- It is pleasing that RBS is recognised for being an attractive employer and has been rated a Top Global Stonewall Employer. The Committee recognises the importance of making RBS a great place to work.

Brand & Communications

- The Committee recognises the importance of the brand strategy. It is pleasing to see the progress made in key metrics, with brand reputation of NatWest and Royal Bank of Scotland reaching a 5 year high in July 2017.

ESE Issues

- While we saw a drop in our Dow Jones Sustainability Index rating this year we have retained our place in the FTSE4GOOD index and achieved a leadership category listing in the Carbon Disclosure Project Index (A-) for the second year running.

My thanks go to the Committee members and attendees for their contribution and support throughout the year. I am also delighted that the proactive work being done by our Sustainable Banking team has been recognised externally, with the award of Sustainability Team of the Year at the Ethical Corporate Responsible Business Awards.

As you will have seen earlier in the report, I intend to stand down as a director of RBS in the coming months. I have thoroughly enjoyed my time as Chairman of SBC and have been pleased by the progress and positive changes that are underway as we remain committed to building a sustainable bank that is focused on delivering for a diversity of stakeholders. I look forward to handing over the role of Committee Chairman to Mike Rogers who has been an engaged and valuable member of SBC since 2016.

Penny Hughes

Chairman of the Sustainable Banking Committee

22 February 2018

Report of the Sustainable Banking Committee

Report of the Sustainable Banking Committee

Meetings

The Sustainable Banking Committee held six scheduled Committee meetings in 2017 which were attended by the Chairman, senior representatives from the customer-facing franchises as well as Human Resources, Sustainability, Risk, Conduct & Restructuring, Communications & Marketing, and the Chief Economist.

Stakeholder engagement

The Committee runs a proactive engagement programme and in 2017 met with twenty external stakeholders. The purpose is to listen and understand where RBS could do more.

In 2017 we held four such external engagement sessions covering the following topics:

- how digital tools and programmes can enhance financial capability and the opportunity for RBS to take a leadership role in this area;
- housing affordability and the role RBS could play in helping to address the housing crisis;
- how RBS could develop its approach and strategies to manage climate change risk; and
- the risks and opportunities that technological disruption brings.

We enhanced our engagement programme in 2017 gaining first hand insight into digital and FinTech centred transformation and its impact on customer behaviour. This was complemented by an additional session with management on open banking. This is an increasing area of interest and focus for RBS and it is important that SBC has a detailed understanding of the opportunities and issues this presents.

The Committee also recognises the importance of engaging with a wide range of stakeholders so members visited Business Banking and Mortgages during 2017, providing valuable frontline colleague and customer insight. We also hosted a lunch with representatives from our Employee Led Networks. This allowed the Committee to hear first hand what it feels like to work for RBS. The themes from this session were reported to the Board to provide insight into the issues facing our employees.

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Following the sessions opportunities for follow up, further engagement and challenge to management are identified. In December, we welcomed back a number of our past stakeholders to share the progress made and to continue engagement.

Membership

During 2017 The Sustainable Banking Committee consisted of five independent non-executive directors. The Chairman and members of the SBC, together with their attendance at scheduled meetings in 2017, are shown below.

	Attended/ scheduled
Penny Hughes (Chairman)	6/6
Alison Davis	6/6
Robert Gillespie	6/6
Mike Rogers	6/6
Yasmin Jetha(1)	3/3

Note:

(1) Appointed to the Committee with effect from 3 August 2017.

Performance evaluation

The annual review of the effectiveness of the Board and its senior Committees, including the SBC, was conducted internally in 2017. The SBC has considered and discussed the outcomes of this evaluation and accepts the findings. Overall the review concluded that the SBC continued to operate effectively.

The feedback from both members and attendees was very positive, although there was some room for improvement in the information received by the SBC. It was suggested that the scope of SBC could be reviewed to ensure its role is clearly defined and understood as its remit has evolved over the last year.

The outcomes of the evaluation have been reported to the Board and the Committee will track progress during the year.

Role and responsibilities of the Sustainable Banking Committee

Authority is delegated to the SBC by the Board and the SBC reports and makes recommendations to the Board as required. The terms of reference of the SBC are available on rbs.com and these are reviewed annually and approved by the Board. A regular report on the activities of the SBC in fulfilling its responsibilities is provided to the Board.

The principal responsibilities of the SBC are shown below:

Culture and People

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- to receive a regular culture measurement report to monitor progress of embedding the Board approved culture;
- to understand areas of the business where there is an opportunity to improve, supporting and challenging management on their plans;
- to receive updates on what RBS is doing in areas such as wellbeing and inclusion, which form part of how it feels to work here;

Customer

- to oversee customer centricity priorities and how RBS is supporting and engaging with key customer segments;
- to oversee progress being made to achieve the long term target of being number one for customer service, trust and advocacy in each of our chosen businesses;
- to receive updates on complaints including understanding how management is addressing the root causes and how that impacts the customer experience;

Brand & Communications

- to oversee the brand strategy in embedding the bank of brands approach focusing on building equity in our customer brands;
- to oversee actions being taken by management to manage RBS's reputation with reference to how RBS is viewed by our customers, consumers and related interest groups;

ESE Issues

- to consider RBS's environmental strategy and progress against its environmental targets;
- to understand what RBS is doing for financial capability and how we operate in our communities; and
- our wider sustainable banking strategy.

Directors Remuneration Report

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Directors Remuneration Report

Annual statement from Robert Gillespie
Chairman of the Group Performance and Remuneration Committee

the new policy creates a simpler way of aligning the interests of executives with shareholders

Dear Shareholder,

This is my first report as Chairman of the Committee and I would like to start by thanking my predecessor, Sandy Crombie, for all his hard work. Sandy joined the Committee in 2009 and served as Chairman from 2014 until the end of 2017, helping to oversee a great number of positive changes in remuneration practices at RBS. He was also instrumental in introducing a new directors remuneration policy at the 2017 AGM.

I would also like to thank shareholders for their feedback during the development of the policy and for the high level of support received at the AGM. It is right that RBS should continue to be at the forefront of pay reforms and I believe the new policy creates a simpler way of aligning the interests of executives with shareholders. It continues our restrained approach to executive pay and is in line with the growing consensus for companies to develop more tailored remuneration arrangements.

We have moved to a long-term incentive structure with much lower maximum potential awards and where the performance of our executives is assessed on what they reasonably should be expected to achieve, while operating within our risk appetite. This helps to create more predictable outcomes and encourages safe and secure growth.

The policy also supports our cultural aim of making sure that remuneration encourages the right behaviours. Executives are required to build up larger shareholdings and retain them for longer. This creates stronger alignment with the experience of shareholders both during and after employment.

Implementation of policy for executive directors in 2018

No changes are being made at this time to the fixed pay arrangements for executive directors. Variable pay continues to be delivered entirely in shares as long-term incentive (LTI) awards with no annual bonus. Members of the Executive Committee are on a similar remuneration construct.

The first LTI awards under the new policy will be granted in early 2018, following an assessment of performance over 2017. The assessment determined that overall performance had been strong, particularly in relation to financial and people & culture measures, but a modest downwards adjustment was considered appropriate as the desired risk and customer performance had not been achieved in full. Details of the assessment against the objectives and the award levels can be found in the report.

A further assessment will be undertaken after three years to ensure that sustainable performance has been delivered prior to vesting. Subject to this assessment, the shares will vest in equal amounts over years three to seven from the date of grant, followed by an additional 12 month retention period post vesting.

Financial performance and pay decisions for 2017

It is clear we have a strong underlying business capable of generating profits and sustainable returns for shareholders. Income has risen, costs have fallen and our capital strength has improved further during the year. A number of legacy issues were settled in 2017 including the rights issue litigation and the Federal Housing Finance Agency settlement relating to RMBS. In addition, approval was obtained for the alternative remedies package for the business previously described as Williams & Glyn. Efforts continue to be made to resolve the outstanding RMBS litigation though the timetable for resolution is outside of the control of management.

For executive directors, performance has been assessed for the long-term incentive plan granted in 2015 following the end of the performance period. The vesting reflects improvements in the Economic Profit, CET1 ratio and people measures, with adjustments in areas where performance did not meet targets over the three year period, such as total shareholder return.

In terms of other pay decisions, the bonus pool for 2017 is £342m, which is £1m lower than 2016, reflecting our transition to simpler and more stable pay structures. The average bonus amounts remain relatively modest with 68% of all bonuses awarded amounting to £5,000 or less. Immediate cash bonuses continue to be limited to £2,000. Since 2010, the bonus pool has reduced by around 75% as a result of decisions taken by the Committee and the move towards a smaller bank with a culture focused on service excellence rather than sales.

Broader pay policy

The Committee also oversees the broader employee pay policy. We continue to make good progress in ensuring that employees are paid fairly and are supported by simple and transparent pay structures. Over the last two years we have removed variable pay for frontline and clerical employees with increases to their fixed pay instead, which provides greater certainty. As a result, 26,500 employees are compensated solely by fixed pay and benefits. Our rates of pay exceed the Living Wage and changes have been introduced so that people performing similar roles are paid more consistently.

We believe that having an engaged and inclusive workforce is a key part of a successful business. I am greatly encouraged by the latest employee engagement score which has risen significantly during 2017 and is now above the Global Financial Services norm. We are confident that we pay our employees fairly. We keep our HR policies and processes under review to ensure we do so. Gender Pay Gap information is also being included for the first time as part of the Strategic Report section, along with the steps we are taking to address the position.

Looking ahead

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Arrangements will be put in place in 2018 to provide additional oversight of remuneration across key RBS entities post ring-fencing. In addition, the government's proposed governance and executive pay reforms are due to be finalised in the coming months. We welcome the proposals and are currently considering the most effective mechanisms to supplement our existing channels for the employee voice to be heard at Board level.

We remain strong supporters of reforms aimed at improving the effectiveness and transparency of pay structures. I look forward to working with the Committee in considering how we can continue to develop remuneration practices at RBS.

Robert Gillespie

Chairman of the Group Performance and Remuneration Committee

22 February 2018

Directors Remuneration Report

Summary of the remuneration policy for executive directors approved at the 2017 AGM

This page provides a summary of the key design features of the approved policy followed by an outline of how the policy will be implemented for executive directors in 2018.

[Change in maximum remuneration opportunity under the new policy](#)

Directors Remuneration Report

Policy implementation 2018 remuneration arrangements

The salary, benefits, pension and fixed share allowance arrangements remain unchanged from 2017. The LTI award to be granted in 2018 is the first award under the new policy, with a significantly lower maximum award level and a pre-grant assessment based on performance during 2017. A further assessment will also take place three years after grant to consider if sustainable performance has been delivered or if anything has come to light that would impact the vesting level or lead to a cancellation of the award.

	Salary	Standard benefits	Pension	Fixed share allowance	2018 LTI award (after pre-grant assessment set out below)
Ross McEwan	£1,000,000	£26,250	£350,000	£1,000,000	£1,575,000
Ewen Stevenson	£800,000	£26,250	£280,000	£800,000	£1,440,000

Pre-grant performance assessment for 2018 LTI awards

A summary of the assessment is set out below and further details can be found in the annual report on remuneration. The Committee assessed performance against pre-set objectives for 2017, across the core areas of Finance, Risk & Operations, Customers and People & Culture. The Committee considered whether the executive directors had achieved what would reasonably have been expected over the period and then applied its judgement without reference to formulaic targets and weightings.

Financial	Risk & Operations	Customers	People & Culture
<p>Strong financial performance with all of the pre-grant objectives met for 2017.</p> <p>Cost savings of £810m were achieved against a target of £750m, the core franchises achieved adjusted RoTE that met the target of at least 11% and the CET1 ratio was 15.9% against the target of 13%.</p>	<p>Continued improvements in risk profile and culture. There was an increase in the number of franchises and functions achieving the desired control rating of 2, although this had not been reached across every area.</p> <p>Work is well underway in readiness for ring-fencing and the required legal entity changes. The programme remains on track with the critical path still delivering to plan.</p>	<p>NPS performance during 2017 was on-target in 4 of our 6 chosen customer segments. While progress had been made, there was still some room for improvement on NPS scores in certain segments.</p> <p>Customer Trust performance was ahead of target in 2 out of the 5 chosen segments with improvements in 2 further segments.</p>	<p>Employee engagement and leadership scores increased significantly in 2017, with RBS above the Global Financial Services norm. Employee engagement was up 7 points on 2016 and was our highest score to date.</p> <p>Improvements were also made in the assessment of culture under the Banking Standards Board survey together with satisfactory progress towards our target of >30% women in senior roles by 2020.</p>
<p>After considering all the factors above, and taking into account input provided by the Board Risk Committee and the Sustainable Banking Committee, the Committee determined that strong overall performance had been achieved in 2017. All financial objectives had been met or exceeded along with significant improvement across people & culture measures. However, while progress had been made across all areas, the</p>			

Committee concluded that a modest reduction would be appropriate to recognise that the desired risk and customer performance had not been achieved in full. As a result, the Committee determined that a 10% reduction should be applied under the pre-grant assessment for the Chief Executive and the Chief Financial Officer.

Timing of remuneration payments

The percentage vesting boxes in the diagram above show when the share awards are released following the end of the applicable vesting and retention periods.

Directors Remuneration Report

Key features of the remuneration policy for executive directors

The Directors Remuneration Policy was approved by shareholders at the AGM on 11 May 2017. The policy will apply until the 2020 AGM unless changes are required which mandate a revised policy be submitted to shareholders for approval. The table below summarises the key features of the policy for executive directors. In the event of any conflict the approved policy, which can be found under the Board and Governance section of rbs.com, takes precedence over the information set out below.

Element of pay	Operation	Maximum potential value
<p>Salary</p> <p>To provide a competitive level of fixed cash remuneration and aid recruitment and retention of high performing individuals.</p>	<p>Paid monthly in cash and reviewed annually.</p> <p>The rates for 2018 are unchanged:</p> <ul style="list-style-type: none"> • Chief Executive - £1,000,000 • Chief Financial Officer - £800,000 	<p>Future salary increases will not normally be greater than the average salary increase for RBS employees over the period. Other than in exceptional circumstances, the salary will not increase by more than 15% over the course of this policy.</p>
<p>Fixed share allowance</p> <p>To provide fixed pay that reflects the skills and experience required and responsibilities for the role.</p>	<p>A fixed allowance paid entirely in shares. The shares vest immediately subject to any deductions for tax and are released in equal tranches over a three year retention period.</p>	<p>An award of shares with an annual value of up to 100% of salary at the time of award.</p>
<p>Benefits</p> <p>To provide a range of flexible and market competitive benefits that are valued and assist individuals in carrying out their duties effectively.</p>	<p>Executive directors can select from a range of standard benefits including: company car; private medical cover; life assurance; and critical illness insurance. Executive directors are also entitled to travel assistance in connection with company business including the use of a car and driver. RBS will meet the cost of any tax due on the benefit. Further benefits including relocation costs may be offered in line with market practice. RBS may also put in place certain security arrangements for executive directors.</p>	<p>Set level of funding for standard benefits (currently £26,250) which is subject to review.</p> <p>The total value of benefits provided is disclosed each year in the annual report on remuneration.</p>
<p>Pension</p>		<p>35% of salary for current executive directors.</p>

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<p>To encourage planning for retirement and long-term savings.</p>	<p>Provision of a monthly cash pension allowance based on a percentage of salary. Opportunity to use the cash to participate in a defined contribution pension scheme.</p>	<p>25% of salary for new executive directors.</p>
<p>Variable pay award (long-term incentive)</p> <p>To support a culture where individuals are rewarded for the delivery of sustained performance, taking into account RBS's strategic objectives.</p> <p>Delivery in shares with the ability to apply malus adjustments and clawback further supports longer-term alignment with shareholders interests.</p>	<p>LTI awards are subject to:</p> <ul style="list-style-type: none"> • a one year pre-grant performance period; • a pre-vest performance assessment at the end of a three year period, with vesting taking place from years three to seven after grant; • malus prior to vesting and clawback which applies for seven (and potentially up to ten) years from the date of award; and • a 12 month post-vesting retention period. <p>Performance will be assessed in the areas of Finance, Risk & Operations, Customers and People & Culture to determine whether the executive has achieved what would reasonably have been expected in the circumstances. Risk & Control and Stakeholder Perception underpins will also apply which may lead to downwards adjustment.</p>	<p>The maximum award for current directors is:</p> <p>Chief Executive - 175% of salary.</p> <p>Chief Financial Officer - 200% of salary.</p> <p>Prior performance will be taken into account when determining the value of the award at the time of grant.</p> <p>The vesting level of the award can vary between 0% and 100% dependent on the delivery of sustained performance.</p>
<p>Shareholding requirements</p> <p>To ensure executive directors build and continue to hold a significant shareholding over the long term.</p>	<p>Unvested shares from LTI awards will count on a net of tax basis towards meeting the shareholding requirement once the pre-vest performance assessment has taken place. Directors can dispose of up to 25% of the net of tax shares received until the shareholding requirement is met.</p>	<p>Chief Executive - 400% of salary.</p> <p>Chief Financial Officer - 250% of salary.</p>

Directors Remuneration Report

Remuneration for the Chairman and non-executive directors

Element of pay	Operation	Maximum potential value
<p>Fees</p> <p>To reflect the required skills, experience and time commitment.</p>	<p>Fees are paid monthly in cash and reviewed regularly. Additional fees may be paid for new Board Committees provided these are not greater than fees payable for the existing Board Committees.</p> <p>No variable pay is provided so that the Chairman and non-executive directors can maintain appropriate independence.</p>	<p>The rates for the year ahead are set out in the annual report on remuneration.</p> <p>Other than in exceptional circumstances, fees will not increase by more than 15% over the course of the policy.</p>
<p>Benefits</p> <p>To provide a level of benefits in line with market practice.</p>	<p>Reimbursement of reasonable out-of-pocket expenses. The Chairman and non-executive directors are entitled to travel assistance in connection with company business including the use of a car and driver. RBS will meet the cost of any tax due on the benefit. Other benefits may be offered in line with market practice.</p> <p>The Chairman receives private medical cover.</p>	<p>The value of the private medical cover provided to the Chairman and any other benefits will be in line with market rates and disclosed in the annual report on remuneration.</p>

Other policy elements

Provision	Operation
Recruitment policy	The policy on the recruitment of new directors aims to be competitive and to structure pay in line with the framework applicable to current directors, based on the elements of pay detailed in the policy table, recognising that some adjustment to quantum within that framework may be necessary to secure the preferred candidate. A buy-out policy exists to replace awards forfeited or payments foregone which is in line with regulatory requirements. The Committee will minimise buy-outs wherever possible and ensure they are no more generous than, and on substantially similar terms to, the original awards or payments they are replacing.
Notice and termination provisions	<p>Executive directors</p> <p>RBS or the executive director is required to give 12 months' notice to the other party to terminate the executive director's employment. There is discretion for RBS to make a payment in lieu of notice (based on salary only) which is released in monthly instalments. The executive director must take all reasonable steps to find alternative work and any remaining instalments will be reduced as appropriate to offset income from any such work.</p> <p>Chairman and non-executive directors</p>

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	<p>The Chairman and the non-executive directors do not have service contracts, they have letters of appointment. They do not have notice periods and no compensation would be paid in the event of termination of appointment, other than standard payments payable for the period served up to the termination date.</p> <p>On an annual basis, all directors stand for election or re-election by shareholders at the company's AGM. Non-executive directors appointed prior to 2017 do not have a set term as the letter of appointment operates on a rolling basis. From 2017 onwards, new non-executive directors have been appointed for an initial term of three years, commencing from the first election by shareholders. At the end of this period, further terms may be agreed, subject to an overall maximum tenure of nine years. The non-executive directors with terms of appointment that will currently expire unless otherwise renewed at the end of three years are: Mark Seligman (2020 AGM), Yasmin Jetha (2021 AGM) and Dr Lena Wilson (2021 AGM).</p>
Legacy arrangements	<p>RBS can continue to honour any previous commitments or arrangements entered into with current or former directors that may have different terms, including terms agreed prior to appointment as an executive director.</p>
Treatment of outstanding employee share plan awards on termination	<p>Share awards will be treated in accordance with the relevant plan rules as approved by shareholders. In line with the remuneration policy approved by shareholders at the 2017 AGM, LTI awards made in 2018 onwards will involve a significant reduction in maximum opportunity and will not be subject to pro rating for time in good leaver circumstances, for the reasons set out below.</p> <p>RBS is unusual in having no annual bonus, and bonus awards would typically not be subject to pro rating for time. In addition, the impact of regulatory requirements effectively constrains the granting of LTI awards in the year of joining. The combination of these factors means that pro rating of time for good leavers results in executives potentially receiving no variable pay award either for the year of joining or in the final year of employment. This is not consistent with our aim of driving shareholder alignment within our pay construct. Removal of pro rating therefore helps to ensure that executive directors are motivated and retain an appropriate long-term focus up to the point of departure. It also creates higher levels of shareholding for up to eight years post departure meaning executives can be held accountable for, and are financially exposed to, the long-term consequences of their actions.</p> <p>Individuals will qualify for good leaver treatment if they leave due to ill-health, injury, disability, death, retirement (as agreed with RBS), redundancy, the employing company ceasing to be a member of RBS, transfer of the employing business, or any other reason if and to the extent the Committee decides in any particular case.</p>

Directors Remuneration Report

Wider employee considerations

The group-wide remuneration policy applies to all employees. Consistent with our executive remuneration principles, the aim is to deliver a simple and transparent pay policy which promotes the long-term success of RBS. The policy supports a culture where employees are rewarded for delivering sustained performance in line with our risk appetite and for demonstrating the right conduct and behaviours. Further details on the group-wide policy can be found on page 102 to 103.

We are committed to building a motivated and inclusive workforce that is engaged and passionate about achieving our ambition. A summary is set out below on some of the initiatives that have taken place to: simplify pay; ensure fair pay; take employees' views into account; and deliver a great place to work.

Simplifying pay

Providing a simple pay structure supports employees in doing the right thing for customers, allowing them to concentrate on providing excellent customer service.

Steps we have taken to simplify pay since 2015 include:

- the removal of incentives for frontline employees in UK PBB and Ulster Bank Republic of Ireland.
- the removal of discretionary bonus for all Clerical employees in the UK and Republic of Ireland in 2017 and extending this to equivalent roles in India and Poland from 1 January 2018.
- the removal of discretionary bonus for the vast majority of Appointed employees in the UK and the Republic of Ireland from 1 January 2018.
- in all the above cases, an appropriate adjustment has been made to fixed pay instead.
- reducing the number of salary ranges by around 50%.
- removing the long-term incentive element of pay for employees below Executive Committee level.

Fair pay

RBS will only achieve its ambitions if employees believe the pay they receive is appropriate for the work they do.

Steps we have taken to ensure fairness include:

- setting rates of pay that exceed the Living Wage Foundation Benchmarks.
- ensuring that people doing similar roles are paid consistently.
- implementing a more transparent approach by moving more employees to published salary ranges.
- investing in pay levels in recent years, focusing mostly on our junior employees, while not increasing fixed pay for our executive directors.

We are confident that we pay our employees fairly. We keep our HR policies and processes under review to ensure we do so.

Our Gender Pay Gap information has been published and can be found in the 'our colleagues' section of the Strategic Report.

Great place to work

RBS provides a range of resources and supporting tools to make sure individuals are capable and motivated to perform at their best.

Some of the elements of great place to work include:

- **inclusion** - employee led groups play a key role in influencing our inclusion strategy. Over 70% of employees have been trained to tackle unconscious bias and the inclusion score from our employee opinion survey is significantly above the Global Financial Services norm.
- **flexible working** - supporting a positive attitude to flexible working patterns to reflect personal preferences where this can be accommodated.
- **wellbeing** - support for good physical, mental and financial health.
- **excellent training** - support with learning, professional development and further qualifications.
- **good leadership** - equipping managers to help their teams flourish - including our Determined to lead programme which won the Princess Royal training award in 2017.
- **RBSselect** - employees can choose from a range of flexible benefits to help with financial planning and lifestyle choices.
- **share ownership** - opportunity in the UK and Republic of Ireland to participate in employee share plans, with Sharesave 2017 seeing a 26% increase in participation.
- **volunteering** - employees are provided with time off to work with charities and local communities.

Further details on our employee initiatives and successes can be found in the [our colleagues](#) section of the Strategic Report.

Views of employees

Our main listening tool is the biannual employee opinion survey which collects views on a range of topics including pay, engagement, wellbeing, inclusion and leadership.

The 2017 results showed improvement in the majority of categories. The number of employees who believe they are paid fairly for the work they do increased significantly during the year and is above the Global Financial Services norm.

We also have a number of other mechanisms through which we communicate with employees such as:

- regular engagement with employee representatives including Unite in Great Britain and Offshore, the Financial Services Union in Ulster Bank and our European Employee Council.
- question and answer sessions throughout the year to allow employees to hear from, and provide feedback to, members of the Executive Committee and other senior staff.
- in November 2017, the Chief Executive held his first live streaming question and answer session with employees across RBS and over 150 questions were submitted.
- visits by Board members to business areas to hear directly from employees.
- support for employee-led networks which helps raise awareness and influence strategy in a number of areas.

Proposed reforms to the UK Corporate Governance Code build on the theme of ensuring the employee voice is heard at Board level. We are supportive of the proposals and are currently considering the most appropriate options to enhance our existing channels for employee engagement.

Directors Remuneration Report

How risk is reflected in our remuneration process

RBS's approach to remuneration and related policies promotes effective risk management through a clear distinction between fixed remuneration, which reflects the role undertaken by an individual, and variable remuneration, which is directly linked and reflective of performance and can be risk-adjusted. Fixed pay is set at an appropriate level to avoid incentives that are adverse to sound risk management.

Focus on risk is achieved through clear risk input into objectives, performance reviews, the determination of variable pay pools and incentive plan design as well as the application of malus and clawback. The Committee is supported in this by the Board Risk Committee (BRC) and the RBS Risk, Conduct and Restructuring function.

A robust process is used to assess risk performance. A range of measures are considered, specifically the overall Risk Profile; Credit, Regulatory and Conduct Risk; Operational Risk; Enterprise Risk; and Market Risk. Consideration is also given to overall Risk Culture. RBS's remuneration arrangements are in accordance with regulatory requirements and the steps we take to ensure appropriate and thorough risk adjustment are also fully disclosed and discussed with the PRA and the FCA.

Variable pay determination

For the 2017 performance year, RBS operated a robust multi-step process which is a control function led assessment to determine performance and therefore the appropriate bonus pool by franchise and function. At multiple points throughout the process, reference is made against Group-wide business performance (from both affordability and appropriateness perspectives) and the need to distinguish between go-forward franchises and resolution activities.

The process considers a balanced scorecard of performance assessments at the level of each franchise or support function. The assessments are made across financial, customer and people measures. Risk and conduct assessments at the same franchise or functional level are then undertaken to ensure that performance achieved without appropriate consideration of risk culture and risk and conduct controls is not inappropriately rewarded.

BRC reviews any material risk and conduct events and, if appropriate, an underpin may be applied to the individual business and function bonus pools or to the overall bonus pool. BRC may recommend a reduction of a bonus pool if it considers that risk and conduct performance is unacceptable or that the impact of poor risk management has yet to be fully reflected in the respective inputs.

Following further review against overall performance and conduct, the Chief Executive will make a final recommendation to the Committee, informed by all the previous steps in the process and his strategic view of the business. The Committee will then make an independent decision on the final bonus pool taking all of these earlier steps into account.

The assessment process for LTI awards to executive directors is founded on the balanced scorecard approach used for the multi-step bonus pool process, reflecting a consistent risk management performance assessment.

Accountability review process and malus/clawback

The accountability review process was introduced in 2012 to identify any material risk management, control and general policy breach failures and ensure accountability for those events. This allows RBS to respond in instances where new information would change the variable pay decisions made in previous years and/or the decisions to be made in the current year.

Under the accountability review process RBS can apply:

- Malus - to reduce (to zero if appropriate) the amount of any unvested variable pay awards prior to payment;
- Clawback - to recover awards that have already vested; and
- In-year reductions - to adjust variable pay that would have otherwise been awarded for the current year.

Any variable pay awarded to Material Risk Takers from 1 January 2015 onwards is subject to clawback for seven years from the date of grant. For awards made in respect of the 2016 performance year onwards, this period has been extended to ten years for executive directors and other Senior Managers under the Senior Managers Regime where there are outstanding internal or regulatory investigations at the end of the normal seven year clawback period.

Circumstances in which RBS may apply malus, clawback or in-year reduction include:

- the individual being culpable, responsible or ultimately accountable for conduct which results in significant financial losses for RBS;
- the individual failing to meet appropriate standards of fitness and propriety;
- reasonable evidence of an individual's misbehaviour or material error;
- RBS or the individual's relevant business unit suffering a material failure of risk management; and
- for malus and in-year reduction only, circumstances where there has been a material downturn in financial performance.

The above list of circumstances is not exhaustive and RBS may consider any further circumstances that it feels appropriate.

During 2017 a number of issues and events were considered under the accountability review framework. The outcomes covered a range of actions including: reduction and forfeiture of unvested awards through malus; dismissal with forfeiture of unvested awards; and suspension of awards pending further investigation. In addition, reductions have also been applied to current year variable pay awards.

Annual report on remuneration

Annual report on remuneration

The sections audited by the company's auditors, Ernst and Young LLP, are as indicated.

Total remuneration paid to executive directors for 2017 (audited)

	Ross McEwan		Ewen Stevenson	
	2017	2016	2017	2016
	£000	£000	£000	£000
Salary	1,000	1,000	800	800
Fixed share allowance (1)	1,000	1,000	800	800
Benefits (2)	113	127	26	26
Pension (3)	350	350	280	280
Total fixed remuneration	2,463	2,477	1,906	1,906
Annual bonus	n/a	n/a	n/a	n/a
Long-term incentive award (4)	1,024	1,225	1,418	
Total remuneration	3,487	3,702	3,324	1,906

Notes:

(1) The value of the fixed share allowance is based on 100% of salary and, as part of fixed remuneration, it is not subject to any performance conditions.

(2) Includes standard benefit funding of £26,250 per annum with the remainder for Ross McEwan in 2017 being travel assistance in connection with company business (£67,006), relocation expenses (£17,065) consisting of a flight allowance and assistance with tax return preparation, and home security arrangements. The 2016 benefits figure for Ross McEwan has been amended to include a value for tax return preparation and home security arrangements during that year.

(3) The executive directors receive a monthly cash allowance to help fund pension arrangements but do not participate in the company's defined benefit pension schemes. The executive directors can choose to participate in the company's defined contribution pension arrangements.

(4) The 2017 value relates to an LTI award granted in 2015. Performance has been assessed over the three year period to 31 December 2017 as set out below together with an estimate of the vesting value. The award will vest in two equal tranches in March 2019 and March 2020. The value for 2016 has been amended from the estimated value of £1,030,000 provided in the 2016 report to reflect the actual value on the vesting date in March 2017.

2015 LTI final assessment of performance measures (audited)

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An assessment of performance of each relevant element was provided by internal control functions and PwC assessed relative Total Shareholder Return (TSR) performance against a peer group of comparator banks.

Performance Measures (and weightings)	Performance for minimum vesting	Vesting at minimum	Performance for maximum (100%) vesting	Actual Performance	Vesting outcome	Weighted Vesting %	
Economic Profit (25%)	(£500 million)	25%	£500 million	£613 million	100%	25%	
Relative TSR (25%)	TSR at median	20%	TSR at upper quartile	Below median	0%	0%	
Safe & Secure Bank (25%)	Vesting between 0% - 100%			CET1 ratio: 15.9%	100%	25%	
CET1 ratio - 12.5%	<i>can be qualified by Committee discretion</i>			Cost:income ratio: 55%			
Cost:income ratio 12.5%	CET1 ratio target: 13% (or above) Cost:income ratio target (go-forward bank basis): 56% (or below)						
Customers & People (25%)	Vesting between 0% - 100%			NPS Gap to number 1 of 15.5	0%	68%	17%
Split across advocacy, trust and employee engagement	<i>can be qualified by Committee discretion</i>				70%		
Net Promoter Score (NPS) 6.25%	NPS target: Gap to number 1 of 6.0			NTS: NatWest 59 RBS 22	100%		
Net Trust Score (NTS) 6.25%	NTS target: NatWest 55, RBS 42						
Engagement Index (EI) 12.5%	EI target: within 2 points of Global Financial Services (GFS) norm			EI: 1 point above GFS norm			
Initial vesting outcome						67%	
Final vesting outcome post application of underpin						60%	

Economic Profit was based on the go-forward basis and defined as operating profit after tax and preference share charges less tangible net asset value multiplied by the cost of equity. The companies in the relative TSR group for this award were: Barclays, Lloyds Banking Group, HSBC, Standard Chartered, BBVA, BNP Paribas, Crédit Agricole, Credit Suisse Group, Deutsche Bank, Santander, Société Générale, UBS, Unicredit. For the Trust metric of the Customers & People section, the NatWest target was met while the RBS target had been missed. The 70% vesting for this element was calculated in line with the weightings of the brands, split 70%/30% for NatWest/RBS, based on the relative revenues of the respective brands.

In making its final judgement, the Committee considered the overall context of performance, noting positive progress on Economic Profit which had exceeded the stretch target and the strong CET1 ratio and took into account input received from the Board Risk Committee. Significant improvement had also been achieved in employee engagement scores which again had exceeded target. However, the Committee also noted that the NPS, Trust for the RBS brand and relative TSR targets had been missed. Taking all circumstances into account, the Committee determined it would be appropriate to apply the underpin and reduce the final vesting outcome from 67% to 60%.

Annual report on remuneration

2015 LTI vesting amounts included in the total remuneration table (audited)

The executive directors were granted an LTI award in March 2015. The performance conditions ended on 31 December 2017 and have been assessed as set out on the previous page. The average share price over the last three months of the financial year has been used to estimate the value. While the performance conditions have been assessed, the shares will not vest until March 2019 and March 2020.

Performance category	% vesting	Ross McEwan		Ewen Stevenson		
		Maximum shares (1)	Shares due to vest	Maximum shares (1)	Shares due to vest	
Economic Profit	100%	154,624	154,624	214,121	214,121	
Relative TSR	0%	154,624		214,121		
Safe & Secure Bank	100%	154,624	154,624	214,121	214,121	
Customers & People	68%	154,624	105,145	214,121	145,602	
Maximum shares for performance assessment		618,496		856,484		
Initial outcome following assessment (67% vesting)			414,393		573,844	
Final outcome post application of underpin (60% vesting)			371,098	£1,024,230	513,890	£1,418,336

Notes:

(1) The maximum number of shares is calculated in line with the underlying award structure. Each performance category could vest up to 100% of the maximum number of shares subject to the approved policy and the regulatory cap. For the 2015 award, the number of shares capped at grant was 417,486 for Ross McEwan and 578,128 shares for Ewen Stevenson. In both cases the vesting outcomes fall within the respective cap.

(2) Based on a RBS share price of £2.76, the average over the three month period from October to December 2017.

2016 and 2017 LTI awards to executive directors – current assessment (audited)

The table represents an early indication of potential vesting outcomes only based on the position at 31 December 2017. Details of the final performance assessment at the end of the three year period and any use of discretion will be disclosed in the remuneration report for the relevant year. The Committee may consider the proximity of legacy items to the executive directors when assessing the vesting level.

Performance measure	Weighting	Performance for minimum vesting	Vesting at minimum	Performance for maximum vesting	Vesting at maximum	2016 LTI award current assessment	2017 LTI award current assessment

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Economic Profit	25%	Minimum economic profit targets	25%	Performance ahead of the Strategic Plan	100%	Currently tracking behind target	Currently favourable to target
Relative TSR	25%	TSR at median of comparator group	20%	TSR at upper quartile of comparator group	100%	Below median performance for vesting	Currently upper quartile performance for vesting
Safe & Secure Bank	25%	Target ranges set for: CET1 ratio and Cost:income ratio	Vesting between 0% - 100% qualified by Committee discretion taking into account the margin by which targets have been missed or exceeded and any other relevant factors			CET1 ratio is in range for vesting.	CET1 ratio is in range for vesting.
Customers & People	25%	Target ranges set for: Net Promoter Score, Net Trust Score and Employee Engagement				Cost:income ratio currently tracking behind target	Cost:income ratio currently in range for vesting
						Customer measures currently behind target with People measure in range for vesting	Customers & People measures broadly tracking in range for vesting

LTI awards granted during 2017 (audited)

	Grant date	Face value of award (£000s)	Number of shares awarded (1)	% vesting at minimum and maximum	Performance Requirements (2)
Ross McEwan	7 March 2017	2,870	1,188,800	Between 0% - 100% with minimum vesting as set out above	Conditional share awards subject to performance conditions, as set out above, measured over the three year period from 1 January 2017 to 31 December 2019
Ewen Stevenson	7 March 2017	2,305	954,768		

Notes:

(1) The number of shares awarded was calculated in line with the regulatory cap that limits variable pay to the level of fixed pay and for this award equated to approximately 287% of salary. The award price of £2.4142 was calculated based on the average share price over five business days prior to the grant date.

(2) Subject to the achievement of performance conditions, the awards are eligible to vest in four tranches with 50% vesting in 2021 and the remaining 50% split over 2022 to 2024. Malus provisions will apply up until vesting and clawback provisions will also apply for a period of seven years from the date of grant, extended to ten years if events are under investigation at the end of the seven year period.

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Performance assessment framework for LTI awards granted from 2018 onwards

For each of the core performance areas, the Committee will consider whether the executive director has achieved what would reasonably have been expected over the relevant period. The Committee will follow a robust process to review performance against pre-set objectives relevant to RBS's strategic aims, but will apply its judgement without reference to formulaic targets and weightings. Performance will be assessed taking into account circumstances applying over the period. Risk & Control and Stakeholder Perception underpins will also apply under which the Committee, with input from the Board Risk Committee and Sustainable Banking Committee, can consider if there are any other factors that would lead to a downwards adjustment (for example if the achievements are not considered sustainable, or were achieved through excessive risk taking).

The majority of the performance variation will normally take place under the pre-grant assessment, with a further pre-vest assessment to check whether, taking all circumstances into account, a threshold level of sustainable performance has been delivered. Overall, the achievement of reasonable or target performance expectations will deliver full, or nearly full, payout of the LTI awards as long as executives deliver good, sustainable performance. This approach reflects the significantly reduced level of awards compared to the previous policy, creating more predictable outcomes and encouraging safe and secure growth within risk appetite. Each year, the performance factors will be determined in light of RBS's priorities for that year.

Pre-grant assessment for LTI awards to be made in 2018

Core area	Objectives for 2017	Pre-grant assessment in January 2018
Financial	Achieve a cost reduction of at least £750 million. Reasonable performance against budget for the core franchises with adjusted RoTE of at least 11%. CET1 ratio of 13% or more.	Strong financial performance with all targets exceeded for 2017. Year on year cost savings of £810 million were achieved, adjusted RoTE was above the target and the CET1 ratio was 15.9%.
Risk & Operations	RBS blended risk profile of 2; Franchise/ Function control environment rated within appetite at 2, or minimum 3 tracking to 2 within 12 months. Risk Culture to be rated at 3 (Proactive) on a blended basis, with strong tone from the top. Strong oversight of ring-fencing, ensuring timely remediation of issues and maintain delivery as planned.	Continued improvements in risk profile with an increase in the number of franchises and functions rated at 2. While progress had been made, the ultimate desired control rating hadn't been reached across every franchise and function. Risk Culture was assessed overall as Proactive with a small number of exceptions. Work is well underway in readiness for ring-fencing and the required legal entity changes. The programme remains in line with plan for delivery.

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Customers	Increase or maintain number 1 for Net Promoter Scores and increase Trust Scores in our chosen segments.	NPS performance during 2017 was on-target in 4 out of 6 customer segments. While progress had been made, there was still room for improvement on NPS scores and on closing the gap to number 1 in certain segments. Trust was ahead of target in 2 out of the 5 segments with improvements in 2 further segments.
People & Culture	Improvement in employee engagement and leadership scores.	Engagement score increased 7 points and the leadership score increased 5 points since 2016, with both above the Global Financial Services norm. The employee opinion survey showed the best results for 10 years.
	Year on year improvement from the Banking Standards Board (BSB) assessment.	Scores from the BSB survey improved on all items compared to 2016, demonstrating an improved culture throughout the business.
	Progress towards target of >30% women in senior roles by 2020	Satisfactory progress had been made. The target population (top three leadership layers) had increased to 37%, representing an 8% increase since targets were introduced at the end of 2014.

Outcome of the assessment

The Committee also received advice from the Board Risk Committee and the Sustainable Banking Committee in making its final assessment. After considering all the factors above, the Committee determined that good performance and progress towards our long-term goals had been achieved in 2017. Performance had been very strong in relation to financial and people & culture measures but, on balance, a 10% reduction was considered appropriate as risk and customer performance was not fully at the desired level. The resulting award levels are set out below.

	Maximum LTI award level	2018 LTI award level after pre-grant assessment
Chief Executive	£1,750,000	£1,575,000
Chief Financial Officer	£1,600,000	£1,440,000

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Pre-vest assessment for 2018 LTI awards

In addition to the pre-grant assessment detailed on the previous page, a further assessment of performance will take place three years after grant, in 2021, prior to vesting. It is intended to be a look-back at the performance year for which the LTI award was granted to consider whether anything has come to light that would impact the vesting level. The over-arching principle is that delivery of a threshold level of sustainable performance will result in no further adjustment prior to vesting. Once the vested amount has been approved, malus and clawback provisions will continue to apply.

The pre-vest assessment allows the Committee to make a balanced assessment of performance in the round rather than relying on formulaic adjustments. It is to provide comfort that sustainable performance has been delivered since the award, and that nothing new has come to light which might call into question the original award. Adjustments will also be made in the event of underperformance or required risk adjustment.

Factors considered in assessing pre-vest performance

Four core questions will be considered as part of the pre-vest assessment under the themes of Finance; Customers; People; and Risk & Control. When assessing the performance of the year for which the award was made, knowing what we know now and taking into account all circumstances, has RBS:

- (1) Remained safe and secure, taking into account our financial results and capital position?
- (2) Been a good bank for customers taking into account our customer and advocacy performance?
- (3) Operated in an environment in which risk is seen as part of the way we work and think?
- (4) Operated in a way that reflects our stated values?

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In addition, the Committee will consider the potential application of Risk & Control and Stakeholder Perception underpins following advice from the Board Risk Committee and Sustainable Banking Committee. This provides scope to consider significant risk, stakeholder or reputational matters not already captured in the performance assessment.

In determining the final vesting level of the award, the Committee will consider both individual and collective performance which means that there may be different vesting levels by participant. If a threshold level of sustainable performance has been delivered then no further assessment is required and the award vests in full.

Objectives for Performance Year 2018 (for the pre-grant assessment of LTI awards to be made in 2019)

The table below forms the basis of the pre-grant assessment for LTI awards to be made in early 2019. Further details on the 2018 objectives and targets and the assessment of performance against these will be set out in the 2018 Directors' Remuneration Report.

Core area	Description of 2018 Objectives	Measures for assessing pre-grant performance for 2019 LTI awards
Financial & Business Delivery	Run a safe and secure bank	Achieve planned reduction in operating expenses
		Reasonable performance against budget and RoTE target
		Achieve CET1 ratio target
	Implement ring-fencing	Delivery of ring-fencing requirements to satisfy the 1 January 2019 implementation, ensuring timely remediation of issues throughout.
Risk & Control	Improve governance and control environment	Franchise and function control environment to meet the required rating within appetite
	Material progress towards our desired risk culture	Achieve the desired Risk Culture rating with strong tone from the top
Customer & Stakeholder	Achieve planned progress towards becoming number 1 for customer service, trust and advocacy by 2020 in chosen customer segments and brands	Net Promoter Score to evidence progress towards or maintaining the number 1 position in our chosen segments and brands
People & Culture	Build up and strengthen a healthy culture	Year on year improvement in scores from employee engagement and leadership indices
		Culture measured against position in Culture index
		Progress towards 2020 target of number of women in senior roles (at least 30% for each franchise and function)
		Progress towards 2025 target of number of Black Asian Minority Ethnic (BAME) UK employees in the top four layers of RBS (at least 14% for each franchise and function)

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Payments for loss of office (audited)

No payments for loss of office were made to directors during 2017.

Payments to past directors (audited)

There are no payments to past directors to disclose for 2017.

Total remuneration paid to the Chairman and non-executive directors for 2017 (audited)

The US Risk Committee was stood down in May 2017. The Board established a Technology and Innovation Committee with effect from 1 September 2017. This demonstrates the importance the Board places on overseeing and monitoring RBS's strategic direction in relation to technology and innovation. Fees for non-executive directors sitting on the NatWest Markets Working Group, which considers transitional arrangements in preparation for the establishment of the NatWest Markets Board, were brought into line with the other main Board Committees. A Board Oversight Committee was established in September 2017 in order to provide oversight of required enhancements to the governance and risk management practices within Ulster Bank Ireland DAC reporting to the Board, as appropriate. Fees were payable for this Committee with effect from 1 October 2017.

The total fees paid during 2017 are set out below.

		Fees		Benefits		Total	
		2017	2016	2017	2016	2017	2016
Chairman (composite fee)		£000	£000	£000	£000	£000	£000
Howard Davies (1)		750	750	11	8	761	758
Non-executive directors (2)							
	Noms & Gov £000						
	GRG UBI BOC DAC £000 BOC	£000	£000	£000	£000	£000	£000

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	Board £000		GAC £000	RemCo £000	BRC £000	SBC £000	TIC £000	NWM £000		£000	Other £000						
Sandy Crombie (3)	77	15	30	60					15	4	30	231	223	30	38	261	261
Frank Dangeard	77				30		10	18				135	58	3	4	138	62
Alison Davis (4)	77	10		30		30	20					167	147	30	21	197	168
Morten Friis (3)	77		30		30						11	148	159	42	39	190	198
Robert Gillespie	77	15		30		30		30	15			197	210	11	10	208	220
John Hughes (5)																	
Penny Hughes (4)	77	5			30	60			15			187	178	11	8	198	186
Yasmin Jetha (5)	42					13	10					65		2		67	
Brendan Nelson	77	15	60		30				30	4		216	211	23	31	239	242
Baroness Noakes (3)(4)	77	5	30		60				15	4	5	196	192	16	8	212	200
Mike Rogers	77			30		30						137	88	16	11	153	99
Mark Seligman (4)(5)	59	5								4		68		4		72	

Notes:

- (1) The benefits column for Howard Davies includes private medical cover.
- (2) In line with market practice, non-executive directors are reimbursed expenses incurred in connection with travel and attendance at Board meetings. HMRC has confirmed that it deems these expenses as taxable where the Board meetings take place at the company's main offices in London and Edinburgh. The value in the benefits column above, including restated amounts for 2016, is the value of the assistance provided together with the associated tax liability which RBS settles on behalf of the non-executive directors.
- (3) Under the 'Other' column, Sandy Crombie received fees as the Senior Independent Director. Morten Friis and Baroness Noakes received fees in respect of the US Risk Committee until it was stood down on 11 May 2017.
- (4) Alison Davis stepped down from the Nominations and Governance Committee and Penny Hughes, Baroness Noakes and Mark Seligman were appointed to the Nominations and Governance Committee during the year.
- (5) Mark Seligman joined the Board on 1 April 2017 and Yasmin Jetha joined the Board on 21 June 2017. John Hughes joined the Board on 21 June 2017 but stepped down with effect from 1 September 2017 due to health reasons. Mr Hughes made a voluntary decision to repay the fees that he received for this period.

Key to table:

Noms & Gov	Group Nominations and Governance Committee
GAC	Group Audit Committee
RemCo	Group Performance and Remuneration Committee
BRC	Board Risk Committee
SBC	Sustainable Banking Committee
TIC	Technology and Innovation Committee
NWM	NatWest Markets Working Group
GRG BOC	Board Oversight Committee for the GRG business areas
UBI DAC BOC	Board Oversight Committee for the Ulster Bank Ireland business

Annual report on remuneration

Implementation of remuneration policy in 2018

Details of remuneration to be awarded in 2018 to executive directors are set out below. The salary, benefits, pension and fixed share allowance arrangements are unchanged from 2017. The LTI award is due to be granted in March 2018 following the pre-grant assessment of performance over 2017. Details of the assessment are set out on page 93. Subject to a further pre-vest assessment of performance at the end of three years, the award will vest in equal amounts between years three to seven from the date of grant. LTI awards are also subject to malus during the vesting period and clawback provisions for a period of seven years from the date of grant, extended to ten years if events are under investigation at the end of the normal seven-year clawback period.

Executive directors remuneration to be awarded in 2018

	Salary	Standard benefits	Pension 35% of salary	Fixed share allowance 100% of salary (1)	LTI award following pre-grant assessment
Chief Executive	£1,000,000	£26,250 (2)	£350,000	£1,000,000	£1,575,000
Chief Financial Officer	£800,000	£26,250	£280,000	£800,000	£1,440,000

Notes:

(1) Fixed share allowance will be payable broadly in arrears, currently in two instalments per year, and the shares will be released in equal tranches over a three year period.

(2) Amount shown relates to standard benefit funding. Executive directors are also entitled to benefits in line with the stated policy including assistance with travel and security arrangements and the Chief Executive is entitled to a flight allowance and assistance with tax return preparation as part of his relocation arrangements. The value of benefits will be disclosed each year in the total remuneration table.

Chairman and non-executive directors fees for 2018

The level of fees for attendance at Board and Board Committee meetings remains unchanged from 2017. A summary of the annual fees payable for 2018 is set out below.

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Chairman (composite fee)		£750,000
Non-executive director basic fee		£80,000
Senior Independent Director		£30,000
Board Risk Committee		
Group Audit Committee		
Group Performance and Remuneration Committee	Member	£30,000
Sustainable Banking Committee	Chairman	£60,000
Technology and Innovation Committee		
NatWest Markets Working Group		
GRG Board Oversight Committee	Member	£15,000
Ulster Bank Ireland DAC Board Oversight Committee	Chairman	£30,000
Group Nominations and Governance Committee	Member	£15,000

Other directorships

Agreement from the Board must be sought before directors accept any additional roles outside of RBS. Procedures are in place to make sure that regulatory limits on the number of directorships held are complied with. The Board would also consider whether it was appropriate for executive directors to retain any remuneration receivable in respect of any external directorships, taking into account the nature of the appointment.

Neither of the executive directors holds a non-executive director role at any other company at this time. Details of the directorships held by other directors can be found in the biographies section of the corporate governance report.

Directors interests in RBS shares and shareholding requirements

The shareholding requirement is to hold shares to the value of 400% of salary for the Chief Executive and 250% of salary for the Chief Financial Officer. Unvested shares from LTI awards will count on a net of tax basis towards meeting the shareholding requirement once the pre-vest performance assessment has taken place, at the end of the three year period. Once the respective retention periods have passed, directors are permitted to dispose of up to 25% of the shares received until the shareholding requirement is met. As set out below, the executive directors exceeded the shareholding requirement as at 31 December 2017. There are no shareholding requirements for non-executive directors.

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Shareholding requirements for executive directors

Notes:

(1) Ross McEwan holds 201,189 shares from his 2015 and 2016 fixed share allowances that are included in the total shares beneficially owned below but these have been excluded from the shareholding requirements calculation as he will transfer these shares to charity at the end of the retention period.

(2) Value of shares held is based on the share price of £2.78 as at 31 December 2017. During the year ended 31 December 2017, the share price ranged from £2.15 to £2.86.

Share interests held by directors (audited)

	Shares owned at 31 December 2017 (or date of cessation if earlier)	% of issued share capital	Value (£) (1,2)	% of shareholding requirement met (3)	Unvested Long-term incentive awards	Unvested Deferral Plan awards
Ross McEwan	2,052,193	0.017152	£5,145,791	514.6%	2,793,493	
Ewen Stevenson	1,103,940	0.009227	£3,068,953	383.6%	2,485,320	
Howard Davies	41,000	0.000343				
Sandy Crombie	20,000	0.000167				
Frank Dangeard						
Alison Davis	20,000	0.000167				
Morten Friis (4)	20,000	0.000167				
Robert Gillespie	25,000	0.000209				
John Hughes						
Penny Hughes	562	0.000005				
Yasmin Jetha						

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Brendan Nelson	12,001	0.000100
Baroness Noakes	41,000	0.000343
Mike Rogers		
Mark Seligman	20,000	0.000167

Notes:

- (1) Ross McEwan holds 201,189 shares from his 2015 and 2016 fixed share allowances that are included in the total shares beneficially owned but these have been excluded from the shareholding requirements calculation as he will transfer these shares to charity at the end of the retention period.
- (2) Value of shares held is based on the share price of £2.78 as at 31 December 2017. During the year ended 31 December 2017, the share price ranged from £2.15 to £2.86.
- (3) The current shareholding requirement is to hold shares to the value of 400% of salary for the Chief Executive and 250% of salary for the Chief Financial Officer. Unvested shares from LTI awards will count on a net of tax basis towards meeting the shareholding requirement once the pre-vest performance assessment has taken place, at the end of the three year period. Once the respective retention periods have passed, directors are permitted to dispose of up to 25% of the shares received until the shareholding requirement is met. The executive directors exceeded the shareholding requirement as at 31 December 2017. There are no shareholding requirements for non-executive directors.
- (4) Interest is 10,000 American Depository Receipts representing 20,000 ordinary shares.

The interests shown above include shares held by persons closely associated with the directors. As at 22 February 2018, there were no changes to the directors' interests in shares shown above. John Hughes stepped down from the Board on 1 September 2017 and did not hold any RBS shares at the date of cessation. Sandy Crombie stepped down from the Board with effect from 1 January 2018. Dr Lena Wilson joined the Board with effect from 1 January 2018 and as at 22 February 2018 she did not hold any RBS shares.

Directors' interests under the company's share plans (audited)

Long-term incentive awards

	Awards held at 1 January 2017	Awards granted in 2017	Award price £	Awards lapsed in 2017	Awards vested in 2017	Market price on vesting £	Value on vesting £	Awards held at 31 December 2017	Expected vesting date
Ross McEwan	915,193		3.28	402,684	512,509	2.39	1,224,897		
	417,486		3.74					417,486	06.03.19 06.03.20
	1,187,207		2.26					1,187,207	08.03.20 08.03.21
		1,188,800	2.41					1,188,800	07.03.21 07.03.24
	2,519,886	1,188,800		402,684	512,509			2,793,493	
Ewen Stevenson	288,257(1)		3.27		288,257	2.39	688,934		
	578,128		3.74					578,128	06.03.19 06.03.20
	952,424		2.26					952,424	08.03.20 08.03.21
		954,768	2.41					954,768	07.03.21 07.03.24
	1,818,809	954,768			288,257			2,485,320	

Note:

- (1) Award granted to Ewen Stevenson on appointment in May 2014 to replace awards forfeited on leaving Credit Suisse.

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Total Shareholder Return (TSR) performance

The graph below shows the performance of RBS over the past nine years in terms of TSR 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 TSR for FTSE UK banks for the same period has been added for comparison. *Source: Datastream*

Chief Executive pay over same period

	2009	2010	2011	2012	2013 (1)	2014	2015	2016	2017
Total remuneration (£000s)					393 (RM)	1,878	3,492	3,702	3,487
Annual bonus against maximum opportunity	1,647 0%	3,687 85%	1,646 0%	1,646 0%	1,235 (SH) 0%	n/a	n/a	n/a	n/a

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LTI vesting rates against maximum opportunity 0% 0% 0% 0% 0% 73% 62% 56% 89%

Notes:

- (1) 2013 remuneration includes Stephen Hester (SH) as Chief Executive for the period to 30 September and Ross McEwan (RM) for the period from 1 October to 31 December.
- (2) Figures have been amended where appropriate to reflect any restatement of prior year amounts, for example, to reflect the actual rather than estimated value of LTI vestings as part of the total remuneration figure and any revisions to the value of benefits provided.
- (3) The maximum opportunity is set according to the approved policy and, for LTI awards granted in 2015 and onwards, the regulatory cap.

Change in Chief Executive pay compared with employees

The table below shows the percentage change in remuneration for the Chief Executive between 2016 and 2017 compared with the percentage change in the average remuneration of RBS employees based in the UK. In each case, remuneration is based on salary, benefits and annual bonus. The Chief Executive also receives a fixed share allowance as part of his fixed pay and this remains unchanged over the period.

	Salary 2016 to 2017 change	Benefits 2016 to 2017 change	Annual Bonus 2016 to 2017 change
Chief Executive (1)	0%	0%	n/a
UK employees (2)	3.91%	3.32%	10.69%

Notes:

- (1) Executive directors are not eligible for an annual bonus. Standard benefit funding for executive directors remained unchanged between 2016 and 2017. The benefits for the Chief Executive excludes other benefits such as travel assistance in connection with company business and relocation benefits, the value of which is disclosed each year in the total remuneration table.
- (2) The data represents full year average salary costs of the UK based employee population, which covers the majority of RBS employees and is considered to be the most representative comparator group. The increase in the average annual bonus is driven in part by the one time impact of the removal of LTI eligibility for employees below the Executive Committee in 2017, with these employees now eligible for an annual discretionary bonus award only.

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Relative importance of spend on pay

The table below shows a comparison of remuneration expenditure against other distributions and charges.

	2017 £m	2016 £m	change
Remuneration paid to all employees (1)	4,217	4,670	(10%)
Distributions to holders of ordinary shares			
Distributions to holders of preference shares and paid-in equity (2)	628	1,697	(63%)
Taxation and other charges recognised in the income statement:			
- Social security, Bank levy and Corporation tax	1,100	747	47%
- Irrecoverable VAT and other indirect taxes incurred by RBS (3)	533	697	(24%)

Notes:

- (1) Remuneration paid to all employees represents total staff expenses per Note 3 to the Financial Statements, exclusive of social security and other staff costs.
- (2) Includes final payment relating to the Dividend Access Share of £1,193 million in 2016.
- (3) Input VAT and other indirect taxes not recoverable by RBS due to it being partially exempt.

The items above have been included as they reflect the key stakeholders for RBS and the major categories of distributions and charges made by RBS.

Consideration of matters relating to directors remuneration

Membership of the Group Performance and Remuneration Committee

All members of the Committee are independent non-executive directors. The Committee held seven scheduled meetings in 2017 and a further three ad hoc meetings.

Alison Davis

Attended/
scheduled
7/7

Robert Gillespie	7/7
Mike Rogers	6/7
Former member	
Sandy Crombie (Chairman)	7/7

Mike Rogers was unable to attend one of the meetings due to personal reasons. Sandy Crombie stepped down from the Committee and the Board with effect from 1 January 2018. At the same time, Robert Gillespie assumed the role of Chairman of the Committee and Mark Seligman became a member of the Committee.

The role and responsibilities of the Committee

The Committee is responsible for:

- approving the remuneration policy for all employees and reviewing the effectiveness of its implementation;
- reviewing performance and making recommendations to the Board on remuneration arrangements for executive directors;
- approving remuneration arrangements for members and formal attendees of the Executive Committee (including control function heads) and employees with total annual compensation which exceeds an amount determined by the Committee, currently £1 million; and
- setting the remuneration framework and principles for employees identified as Material Risk Takers falling within the scope of UK regulatory requirements.

In mitigating potential conflicts of interest, directors are not involved in decisions regarding their own remuneration and remuneration advisers are appointed by the Committee rather than management. The terms of reference of the Committee are reviewed annually and available on rbs.com.

Summary of the principal activity of the Committee in 2017

In addition to its usual business activities, in 2017 the Committee was actively involved in developing the new directors' remuneration policy with key stakeholders. Set out below is a summary of the Committee's other key considerations throughout the year.

First half of 2017

- 2016 performance reviews and remuneration arrangements for executive directors, Executive Committee members and attendees, and high earners.
- Executive Committee members' 2017 objectives.
- Development of the future pay construct for Executive Committee members.
- Approval of variable pay allocations and the 2016 Directors' Remuneration Report.
- Review of the vesting levels for LTI awards granted in 2014 and the interim assessment of 2015/16 LTI awards.
- Updates on changes in regulation and the regulatory attestation process.
- Review of domestic and international peer group pay and remuneration disclosures.

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- Progress update on the Committee's performance evaluation.
- Review of pay outcomes for 2016.

Second half of 2017

- Half-year and year end performance reviews for executive directors, Executive Committee members and attendees.
- Executive Committee members' annual common objectives for 2018.
- Simplification of the pay construct for individuals below Executive Committee level.
- Review of retirement and leaver policies.
- Annual review of external advisers to the Committee.
- Remuneration governance across legal entities, international locations and the impact of ring-fencing.
- External stakeholder engagement plan.
- Approval of the 2017 employee Sharesave offer.
- Review of draft Directors' Remuneration Report for 2017.
- Risk / remuneration process review.
- The annual evaluation of the Committee's performance.

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Performance evaluation process

The Committee has considered the findings of the annual review of the effectiveness of the Committee. This year the evaluation process was conducted internally by the Deputy Secretary and overseen by the Company Secretary.

The feedback was very positive with most issues being rated either excellent or good. Positive comments were received on the Committee's composition and how effective the Committee had been on focusing on 'big picture' issues as well as external themes and developments. The new executive director pay construct was seen as a good example of the Committee being forward thinking and innovative.

While the quality of information was generally considered to be good, some responses indicated there was scope for better comparative data and context. A number of Committee members and attendees suggested that, while the right things were on the agenda and meetings were well run, further consideration should be given to the number of meetings during the year.

The overall conclusion was that the Committee operated effectively during 2017 and fulfilled its remit as set out in its terms of reference. Actions were agreed as part of the evaluation and progress will be tracked and reported to the Committee biannually.

Advisers to the Committee

PricewaterhouseCoopers LLP (PwC) was appointed as the Committee's remuneration advisers on 14 September 2010. A formal review of potential advisers was undertaken in 2017. This considered the ability of the providers to offer high quality advice and strategic thinking, the strength and depth of the personnel and the associated level of fees. Following the review, the Committee agreed to retain the services of PwC. The Committee will continue to review the performance of its advisers each year. PwC is a signatory to the voluntary code of conduct in relation to remuneration consulting in the UK.

As well as receiving advice from PwC in 2017, the Committee took account at meetings of the views of the Chairman; the Chief Executive; the Chief Financial Officer; the Chief HR Officer; the Director of Reward, Pension & Benefits; the Company Secretary; and the Chief Risk Officer. The Committee also received input from the Board Risk Committee, the Group Audit Committee and the Sustainable Banking Committee.

PwC also provides professional services in the ordinary course of business including assurance, advisory, tax and legal advice to RBS subsidiaries. There are processes in place to ensure the advice received by the Committee is independent of any support provided to management.

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The fees paid to PwC for advising the Committee in relation to directors' remuneration were charged on a time/cost basis until September 2017. A fixed fee structure has operated from October 2017 onwards to cover standard services with any exceptional items charged on a time/cost basis. The fees for 2017 in relation to directors' remuneration amounted to £170,476 excluding VAT (2016 - £214,706).

Statement of shareholder voting

The tables below set out the voting by shareholders on the resolutions to approve the Annual Report on Remuneration and the Directors Remuneration Policy at the AGM on 11 May 2017.

Annual Report on Remuneration 2017 AGM

For	Against	Total votes cast	Withheld
43,612,488,456 (99.60%)	173,420,916 (0.40%)	43,785,909,372	14,256,744

Directors Remuneration Policy 2017 AGM

For	Against	Total votes cast	Withheld
42,143,861,332 (96.33%)	1,603,968,780 (3.67%)	43,747,830,112	40,411,396

Shareholder dilution

The company meets its employee share plan obligations through a combination of new issue shares and market purchase shares. In line with the Investment Association's Principles of Remuneration, RBS's employee share plans contain monitored limits that govern the number of shares that may be issued to satisfy share plan awards.

Robert Gillespie

Chairman of the Group Performance and Remuneration Committee

22 February 2018

Other Remuneration Disclosures

This section contains a number of voluntary disclosures on remuneration as well as disclosures which are required in accordance with Article 450 of the Capital Requirements Regulation. This section should be read in conjunction with both the Directors Remuneration Report and the Annual Report on Remuneration (pages 84 to 100).

Remuneration of the eight highest paid senior executives below Board (1)

	Executive 1	Executive 2	Executive 3	Executive 4	Executive 5	Executive 6	Executive 7	Executive 8
	£000	£000	£000	£000	£000	£000	£000	£000
Fixed pay (cash)	650	700	738	800	800	600	450	381
Fixed allowances	650	700	738	800	800	600	225	166
Annual bonus								
Long-term incentive awards (vested value)	638	437	346	109	109	365		73
Total remuneration (2)	1,938	1,837	1,822	1,709	1,709	1,565	675	620

Notes:

- (1) Remuneration earned in 2017 for eight members of the Executive Committee.
- (2) Disclosure includes prior year long-term incentive awards which vested during 2017. The amounts shown reflect the value of vested awards using the share price on the day the awards vested.

All staff total remuneration

the average salary for all employees is £32,785
12,445 employees earn between £50,000 and £100,000
5,025 employees earn between £100,000 and £250,000
934 employees earn total remuneration over £250,000

Total remuneration by band for all employees earning > 1 million

	Number of employees 2017
1.0m - 1.5m	50
1.5m - 2.0m	18
2.0m - 2.5m	9
2.5m - 3.0m	2
3.0m - 3.5m	1
3.5m - 4.0m	1
4.0m - 4.5m	1
4.5m - 5.0m	0
5.0m - 6.0m	1
Total	83

Notes:

- (1) Total remuneration in the table above includes fixed pay, pension and benefit funding and variable pay.
- (2) Executive directors are not included. The table is based on an exchange rate where applicable of 1.141 to £1 as at 31 December 2017.

Employees that earned total remuneration of over 1 million in 2017 represent just 0.1% of our employees. This number reduces to 68 employees if we exclude pension and benefit funding. These employees include those who manage major businesses and functions with responsibility for significant assets, earnings or areas of strategic activity and can be grouped as follows:

- The Chief Executives responsible for each area and their direct reports.
- Employees managing large businesses within a franchise.
- Income generators responsible for high levels of income including those involved in managing trading activity and supporting clients with more complex financial transactions, including financial restructuring.
- Those responsible for managing our balance sheet and liquidity and funding positions across the business.
- Employees who managed the successful disposal of assets in Capital Resolution, reducing RBS's capital requirements.

Other Remuneration Disclosures

Our remuneration policy for all employees

The remuneration policy supports the business strategy and is designed to promote the long-term success of RBS. It aims to reward employees for delivering good performance provided this is achieved in a manner consistent with our values and within acceptable risk parameters. The remuneration policy applies the same principles to all employees, including Material Risk Takers (MRTs), with some minor adjustments to the policy where necessary to comply with local regulatory requirements. The key elements of the policy are set out below.

Element of pay	Objective	Operation
Base salary	To provide a competitive level of fixed cash remuneration.	Base salaries are reviewed annually and should reflect the talents, skills and competencies that the individual brings to the business.
Role-based allowance	To provide fixed pay that reflects the skills and experience required for the role.	<p>Role-based allowances are a fixed allowance which form an element of the employee's overall fixed remuneration for regulatory requirements and are based on the role the individual performs.</p> <p>The allowances are pre-determined, permanent, and can only be adjusted or cancelled if an employee relinquishes the role or responsibilities which made them eligible for the allowance. They are not intended to be adjusted other than where there is a change of role.</p> <p>They are delivered in cash and/or shares depending on the level of the allowance and the seniority of the recipient. Shares are subject to an appropriate retention period, not less than six months.</p>
Benefits and pension	To provide a range of flexible and competitive benefits.	<p>In most jurisdictions, employee benefits or a cash equivalent are provided from a flexible benefits account.</p> <p>Pension forms part of fixed remuneration and RBS does not as a rule award discretionary pension benefits.</p>
Annual bonus	To support a culture where employees recognise the importance of serving customers well and are rewarded for superior performance.	The annual bonus pool is based on a balanced scorecard of measures including Financial, Customers, People and Risk & Conduct measures. Allocation from the pool depends on performance of the franchise or function and the individual.

Individual performance assessment is supported by a structured performance management framework. This is designed to assess performance against longer term business requirements across a range of financial and non-financial metrics as well as an evaluation of adherence to internal controls and risk management.

The performance measures are set in line with the business strategy and typically include: financial measures such as return on equity; cost:income ratio; expenses and headcount (dependent on the franchise / function); net promoter score and/or customer satisfaction to assess customer advocacy; and internal survey results to assess progress in employee engagement.

Risk and conduct performance is also taken into account. Control functions are assessed independently of the business units that they oversee.

For awards made in respect of the 2017 performance year, immediate cash awards continue to be limited to a maximum of £2,000. In line with regulatory requirements, a significant proportion of annual bonus awards for our more senior employees is deferred and includes partial delivery in shares.

The deferral period varies from three years for standard MRTs, rising to five years for individuals identified as Risk Manager MRTs and seven years for Senior Managers under the UK's Senior Managers Regime. All awards are subject to malus and clawback provisions. For MRTs, a minimum of 50% of any annual bonus is delivered in shares and a twelve month retention period will apply post vesting in line with regulatory requirements.

Other Remuneration Disclosures

Long-term incentive awards	To support a culture where good performance against a full range of measures will be rewarded. To encourage the creation of value over the long term and to align rewards with the returns to shareholders.	<p>RBS provides certain employees in senior roles with long-term incentive awards. For awards made in respect of the 2017 performance year, the population receiving long-term incentive awards will be limited to executive directors and members of the RBS Executive Committee.</p> <p>Awards will be subject to pre-grant and pre-vest performance assessments that consider progress against Financial, Risk & Operations, Customers and People & Culture measures, aligned with RBS's strategic aims. Vesting will take place over a three to seven year period following grant.</p> <p>The number of shares that vest under the award may vary between 0% -100% depending on the performance achieved. Awards are subject to malus and clawback provisions and a twelve month retention period applies post vesting.</p>
Shareholding requirements	To promote long-term alignment between senior executives and shareholders.	Executive directors and members of the Executive Committee are required to build up and hold a shareholding equivalent to a percentage of salary. There is a restriction on the number of shares that individuals can sell until the requirement is met.
Other share plans	To offer employees in certain jurisdictions the opportunity to acquire shares.	Employees in certain countries are eligible to contribute to share plans which are not subject to performance conditions.

Criteria for identifying MRTs

The European Banking Authority has issued criteria for identifying MRT roles, those staff whose professional activities have a material influence over RBS's performance or risk profile. The criteria are both qualitative (based on the nature of the role) and quantitative (for example those who exceed the stipulated total remuneration threshold based on the previous year's total remuneration).

The qualitative criteria can be summarised as: staff within the management body; senior management; other staff with key functional or managerial responsibilities; staff, individually or as part of a Committee, with authority to approve new business products or to commit to credit risk exposures and market risk transactions above certain levels. The quantitative criteria are: individuals earning 500,000 or more in the previous year; individuals in the top 0.3% of earners in the previous year; individuals who earned more than the lowest paid identified staff per the qualitative criteria, subject to specific exceptions in the criteria. In addition to the qualitative and quantitative criteria, RBS has applied its own minimum standards to identify roles that are considered to have a material influence over its risk profile.

Personal hedging strategies

In accordance with UK regulatory requirements and internal dealing rules that apply to employees, the conditions attached to discretionary share-based awards prohibit the use of any personal hedging strategies to lessen the impact of a reduction in value of such awards. These conditions are explicitly acknowledged and accepted by employees when any share-based awards are granted.

Other Remuneration Disclosures

Remuneration of MRTs

The quantitative disclosures below are made in accordance with Article 450 of the EU Capital Requirements Regulation in relation to 637 employees who have been identified as MRTs.

1. Number of MRTs by business area

	Senior management	Other MRTs	Total
Number of beneficiaries			
Board Executive Directors	2		2
Board Non-Executive Directors		12	12
NatWest Markets	1	248	249
Personal & Business Banking	1	71	72
Commercial & Private Banking	1	91	92
Corporate Functions	2	96	98
Internal Control Functions	1	73	74
All Other Business Areas	2	36	38
Total	10	627	637

2. Aggregate remuneration expenditure

Aggregate remuneration expenditure in respect of 2017 performance was as follows:

	Senior management	Other MRTs	Total
Number of beneficiaries	10	627	637
	£m	£m	£m
Board Executive Directors	7.3		7.3
Board Non-Executive Directors		2.7	2.7
NatWest Markets	3.4	166.7	170.1
Personal & Business Banking	2.5	21.3	23.8
Commercial & Private Banking	3.1	34.2	37.3
Corporate Functions	2.7	37.8	40.5
Internal Control Functions	1.7	23.4	25.1
All Other Business Areas	5.9	20.0	25.9
Total	26.5	306.1	332.6

3. Amounts and form of fixed and variable remuneration

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Fixed remuneration consisted of salaries, allowances, pension and benefit funding.

Fixed remuneration	Senior management	Other MRTs	Total
Number of beneficiaries	10	627	637
	£m	£m	£m
Board Executive Directors	4.3		4.3
Board Non-Executive Directors		2.7	2.7
NatWest Markets	1.9	101.1	103.0
Personal & Business Banking	1.4	15.7	17.2
Commercial & Private Banking	1.8	22.0	23.7
Corporate Functions	1.6	25.6	27.2
Internal Control Functions	1.7	17.3	18.9
All Other Business Areas	3.5	12.9	16.3
Total	16.1	197.2	213.3

Variable remuneration awarded for 2017 performance

Variable remuneration consisted of a combination of annual bonus and long-term incentive awards, deferred over a three to seven year period in accordance with regulatory requirements. Under the RBS bonus deferral structure, immediate cash awards are limited to £2,000 per employee.

Long-term incentive awards vest subject to the extent to which performance conditions are met and can result in zero payment.

Annual bonus	Senior management	Other MRTs	Total
Number of beneficiaries		515	515
		£m	£m
Board Executive Directors			
Board Non-Executive Directors			
<u>NatWest Markets</u>			
Variable remuneration (cash)		0.44	0.44
Deferred remuneration (bonds)		5.02	5.02
Deferred remuneration (shares)		<u>60.15</u>	<u>60.15</u>
		65.61	65.61
<u>Personal & Business Banking</u>			
Variable remuneration (cash)		0.19	0.19
Deferred remuneration (bonds)		1.11	1.11
Deferred remuneration (shares)		<u>4.26</u>	<u>4.26</u>
		5.55	5.55
<u>Commercial & Private Banking</u>			
Variable remuneration (cash)		0.14	0.14
Deferred remuneration (bonds)		1.52	1.52
Deferred remuneration (shares)		<u>10.61</u>	<u>10.61</u>
		12.27	12.27
<u>Corporate Functions</u>			
Variable remuneration (cash)		0.29	0.29
Deferred remuneration (bonds)		1.85	1.85
Deferred remuneration (shares)		<u>10.02</u>	<u>10.02</u>
		12.16	12.16
<u>Internal Control Functions</u>			
Variable remuneration (cash)		0.11	0.11
Deferred remuneration (bonds)		1.18	1.18
Deferred remuneration (shares)		<u>4.88</u>	<u>4.88</u>
		6.17	6.17

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All Other Business Areas

Variable remuneration (cash)	0.06	0.06
Deferred remuneration (bonds)	0.74	0.74
Deferred remuneration (shares)	<u>6.34</u>	<u>6.34</u>
	7.14	7.14
Total	108.90	108.90

	Senior management	Other MRTs	Total
<u>Long-term incentives</u>			
Number of beneficiaries	9		9
	£m		£m
Board Executive Directors	3.02		3.02
Board Non-Executive Directors			
NatWest Markets	1.50		1.50
Personal & Business Banking	1.05		1.05
Commercial & Private Banking	1.30		1.30
Corporate Functions	1.15		1.15
Internal Control Functions			
All Other Business Areas	2.40		2.40
Total	10.42		10.42

Other Remuneration Disclosures

4. Outstanding deferred remuneration through 2017

The table below includes deferred remuneration awarded or paid out in 2017 in respect of prior performance years. Deferred remuneration reduced during the year relates to long-term incentives lapsed when performance conditions are not met, long-term incentives and deferred awards forfeited on leaving and malus adjustments of prior year deferred awards and long-term incentives.

Category of deferred remuneration	Senior Management £m	Other MRTs £m	Total £m
Unvested from prior year	36.5	159.3	195.8
Awarded during year	16.2	122.5	138.7
Paid out	7.1	97.8	104.9
Reduced from prior years	3.9	16.5	20.4
Unvested at year end	41.7	167.5	209.2

5. Guaranteed Awards (including Sign-on awards) and Severance Payments

RBS does not offer Sign-on awards. Guaranteed awards may only be granted to new hires in exceptional circumstances in compensation for awards foregone in their previous company and are limited to the first year of service. No new hire guarantees were made in respect of the 2017 performance year.

Severance payments and / or arrangements can be made to employees who leave RBS in certain situations, including redundancy. Such payments are determined by a pre-determined formula set out within the relevant social plans, policies, agreements or local laws. Where local laws permit, there is a cap on the maximum amount that can be awarded.

No severance payments were made during the financial year in excess of contractual payments, local policies, standards or statutory amounts, other than two exceptions. One payment of £45,500 was made to a former employee in Corporate Functions as a payment in lieu of contractual pension entitlements and one payment of £3,600 was made to a former employee in Commercial & Private Banking as a small variation of standard terms. Where required, remuneration is constrained within the limit of variable to fixed remuneration in accordance with EBA rules.

6. Ratio between fixed and variable remuneration

The variable component of total remuneration for MRTs at RBS shall not exceed 100% of the fixed component. Based on the information disclosed below, the average ratio between fixed and variable remuneration for 2017 is approximately 1 to 0.56. The majority of MRTs are based in the UK.

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	Senior Management	Other MRTs	Total
Ratio of fixed to variable Number of beneficiaries	9	515	524
	ratio	ratio	ratio
Board Executive Directors	1 to 0.7		1 to 0.7
Board Non-Executive Directors		1 to 0	1 to 0
NatWest Markets	1 to 0.79	1 to 0.65	1 to 0.65
Personal & Business Banking	1 to 0.73	1 to 0.35	1 to 0.38
Commercial & Private Banking	1 to 0.74	1 to 0.56	1 to 0.57
Corporate Functions	1 to 0.74	1 to 0.48	1 to 0.49
Internal Control Functions	1 to 0	1 to 0.36	1 to 0.33
All Other Business Areas	1 to 0.69	1 to 0.55	1 to 0.58
Consolidated	1 to 0.65	1 to 0.55	1 to 0.56

7. Discount Rate 2017

Under CRD IV regulations, a notional discount is available which allows variable pay to be awarded at a level that would otherwise exceed the 1:1 ratio, provided that at least 25% of variable pay is delivered in instruments (shares) and deferred over five years. The discount rate was not used for remuneration awarded in respect of the 2017 performance year.

Compliance report

Statement of compliance

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

Throughout the year ended 31 December 2017, RBS has complied with all of the provisions of the UK Corporate Governance Code issued by the Financial Reporting Council dated April 2016 (the Code) except in relation to provision (D.2.2) that the Group Performance and Remuneration Committee should have delegated responsibility for setting remuneration for the Chairman and executive directors. RBS considers that this is a matter which should rightly be reserved for the Board and this is an approach RBS has adopted for a number of years. Remuneration for the executive directors is first considered by the Group Performance and Remuneration Committee which then makes recommendations to the Board for consideration. This approach allows all non-executive directors, and not just those who are members of the Group Performance and Remuneration Committee, to participate in decisions on the executive directors' and the Chairman's remuneration and also allows the executive directors to input to the decision on the Chairman's remuneration. The Board believes this approach is very much in line with the spirit of the Code and no director is involved in decisions regarding his or her own remuneration. We do not anticipate any changes to our approach on this aspect of the Code. Information on how RBS has applied the main principles of the Code can be found in the Corporate governance report on pages 50 to 105. A copy of the Code can be found at www.frc.org.uk.

RBS has also implemented the recommendations arising from the Walker Review and complied in all material respects with the Financial Reporting Council Guidance on Audit Committees issued in September 2012 and April 2016.

Under the US Sarbanes-Oxley Act of 2002, specific standards of corporate governance and business and financial disclosures and controls apply to companies with securities registered in the US. RBS complies with all applicable sections of the US Sarbanes-Oxley Act of 2002, subject to a number of exceptions available to foreign private issuers.

Internal control

Management of The Royal Bank of Scotland Group plc is responsible for the system of internal controls that is designed to maintain effective and efficient operations, compliant with applicable laws and regulations. The system of internal controls is designed to manage, or mitigate, risk to an acceptable residual level rather than eliminate it entirely. Systems of internal control can only provide reasonable and not absolute assurance against material misstatement, fraud or loss.

Management's report on internal control over financial reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for RBS.

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RBS's internal control over financial reporting is a component of an overall system of internal control and is designed to provide reasonable assurance regarding the preparation, reliability and fair presentation of financial statements for external purposes in accordance with International Financial Reporting Standards (IFRS) and includes:

- Policies and procedures that relate to the maintenance of records that, in reasonable detail, fairly and accurately reflect the transactions and disposition of assets.
- Controls providing reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in accordance with IFRS, and that receipts and expenditures are being made only as authorised by management.
- Controls providing reasonable assurance regarding the prevention or timely detection of unauthorised acquisition, use or disposition of assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or because the degree of compliance with policies or procedures may deteriorate.

Management assessed the effectiveness of RBS's internal control over financial reporting as of 31 December 2017 based on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in the 2013 publication of *Internal Control - Integrated Framework*.

Based on its assessment, management believes that, as of 31 December 2017, RBS's internal control over financial reporting is effective.

The effectiveness of RBS's internal control over financial reporting as of 31 December 2017 has been audited by Ernst & Young LLP, RBS's independent registered public accounting firm. The report of the independent registered public accounting firm to the directors of the Royal Bank of Scotland Group plc expresses an unqualified opinion on RBS's internal control over financial reporting as of the 31 December 2017.

Disclosure controls and procedures

Management, including RBS's Chief Executive and Chief Financial Officer, have conducted an evaluation of the effectiveness and design of RBS's disclosure controls and procedures (as such term is defined in the Exchange Act Rule 13a-15(e)). Based on this evaluation, RBS's Chief Executive and Chief Financial Officer concluded that RBS's disclosure controls and procedures were effective as of the end of the period covered by this annual report.

Changes in internal control

There was no change in RBS'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, RBS's internal control over financial reporting.

Compliance report

The New York Stock Exchange

As a foreign private issuer with American Depositary Shares representing ordinary shares, preference shares and debt securities listed on the New York Stock Exchange (the NYSE), RBS is not required to comply with all of the NYSE standards applicable to US domestic companies (the NYSE Standards) provided that it follows home country practice in lieu of the NYSE Standards and discloses any significant ways in which its corporate governance practices differ from the NYSE Standards. RBS is also required to provide an Annual Written Affirmation to the NYSE of its compliance with the mandatory applicable NYSE Standards.

The Group Audit Committee fully complies with the mandatory provisions of the NYSE Standards (including by reference to the rules of the Exchange Act) that relate to the composition, responsibilities and operation of audit committees. In April 2017 RBS submitted its required annual written affirmation to the NYSE confirming its full compliance with those and other applicable provisions. More detailed information about the Group Audit Committee and its work during 2017 is set out in the Group Audit Committee report on pages 65 to 72.

RBS has reviewed its corporate governance arrangements and is satisfied that these are consistent with the NYSE Standards, subject to the following departures: (i) NYSE Standards require the majority of the Board to be independent. The NYSE Standards contain different tests from the Code for determining whether a director is independent. RBS follows the Code's requirements in determining the independence of its directors and currently has 9 independent non-executive directors, one of whom is the senior independent director. (ii) The NYSE Standards require non-management directors to hold regular sessions without management present and that independent directors meet at least once a year. The Code requires the Chairman to hold meetings with non-executive directors without the executives present and non-executive directors are to meet without the Chairman present at least once a year to appraise the Chairman's performance and RBS complies with the requirements of the Code. (iii) The NYSE Standards require that the nominating/corporate governance committee of a listed company be composed entirely of independent directors.

The Chairman of the Board is also the Chairman of the Group Nominations and Governance Committee, which is permitted under the Code (since the Chairman was considered independent on appointment). The terms of reference of the Group Nominations and Governance Committee differ in certain limited respects from the requirements set out in the NYSE Standards, including because the Group Nominations and Governance Committee does not have responsibility for overseeing the evaluation of management. (iv) The NYSE standards require that the compensation committee of a listed company be composed of entirely of independent directors. Although the members of the Group Performance and Remuneration Committee are deemed independent in compliance with the provisions of the Code, the Board has not assessed the independence of the members of the Group Performance and Remuneration Committee and the Group Performance and Remuneration Committee has not assessed the independence of any compensation consultant, legal counsel or other adviser, in each case, in accordance with the independence tests prescribed by the NYSE Standards.

The NYSE Standards require that the compensation committee must have direct responsibility to review and approve the Chief Executive's remuneration.

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As stated at the start of this Compliance Report, in the case of RBS, the Board, rather than the Group Performance and Remuneration Committee, reserves the authority to make the final determination of the remuneration of the Chief Executive. (v) The NYSE Standards require listed companies to adopt and disclose corporate governance guidelines. Throughout the year ended 31 December 2017, RBS has complied with all of the provisions of the Code (subject to the exception described above) and the Code does not require RBS to disclose the full range of corporate governance guidelines with which it complies. (vi) The NYSE Standards require listed companies to adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers. RBS has adopted a code of conduct which is supplemented by a number of key policies and guidance dealing with matters including , among others, anti-bribery and corruption, anti-money laundering, sanctions, confidentiality, inside information, health, safety and environment, conflicts of interest, market conduct and management records. This code of conduct applies to all officers and employees and is fully aligned to the PRA and FCA Conduct Rules which apply to all directors. The Code of Conduct is available to view on RBS s website at rbs.com.

This Compliance report forms part of the Corporate governance report and the Report of the directors.

Report of the directors

The directors present their report together with the audited accounts for the year ended 31 December 2017.

Group structure

The company is a holding company owning the entire issued ordinary share capital of The Royal Bank of Scotland plc, the principal direct operating subsidiary undertaking of the company.

Following placing and open offers in December 2008 and in April 2009, HM Treasury (HMT) owned approximately 70.3% of the enlarged ordinary share capital of the company. In December 2009, the company issued a further £25.5 billion of new capital to HMT in the form of B shares. HMT sold 630 million of its holding of the company's ordinary shares in August 2015. In October 2015 HMT converted its entire holding of 51 billion B shares into 5.1 billion new ordinary shares of £1 each in the company.

At 31 December 2017, HMT's holding in the company's ordinary shares was 70.5%.

RBS Group ring-fencing

The UK ring-fencing legislation requiring the separation of essential banking services from investment banking services will take effect from 1 January 2019.

To comply with these requirements it is RBS's intention to place the majority of the UK and Western European banking business in ring-fenced banking entities under an intermediate holding company. NatWest Markets Plc (NatWest Markets) will be a separate non ring-fenced bank and The Royal Bank of Scotland International (Holdings) Limited (RBSI Holdings) will also be placed outside the ring-fence, both as direct subsidiaries of RBSG.

The final ring-fenced legal structure and the actions to be taken to achieve it, remain subject to, amongst other factors, additional regulatory, Board and other approvals as well as employee information and consultation procedures. All such actions and their respective timings may be subject to change, or additional actions may be required, including as a result of external and internal factors including further regulatory, corporate or other developments.

On 1 January 2017, RBS made a number of key changes to the legal hierarchy of its subsidiaries to support the move towards a ring-fenced structure. As part of continuing preparation to deliver a fully compliant ring-fencing structure by 1 January 2019, it plans to undertake a further series of actions as follows:

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November 2017

On 21 November 2017, The Royal Bank of Scotland plc (RBS plc) applied to the Court of Session in Edinburgh (the Court) to initiate a Ring-Fencing Transfer Scheme (RFTS) under the Financial Services and Markets Act 2000, including:

- Transfer its UK retail & commercial banking business to Adam & Company PLC (Adam);
- Transfer its covered bonds in issue and Mentor business to National Westminster Bank Plc (NatWest); and
- Transfer branches and other properties to either NatWest or Adam.

The RFTS is expected to take effect over the weekend of 28-30 April 2018. At the same time, RBS plc will be renamed NatWest Markets Plc, Adam will be renamed The Royal Bank of Scotland plc and assume banknote-issuing responsibility.

May 2018

In May 2018, RBS intends to commence, in the Court, a second RFTS to transfer certain derivatives from NatWest to NatWest Markets Plc (former RBS plc). If approved by the Court, the transfers are expected to be implemented in August 2018.

July 2018

In July 2018, RBS plans to restructure the NatWest Markets Plc (former RBS plc) capital structure via a Court approved capital reduction. As part of this restructure, the shares in NatWest Holdings Limited, which owns the ring-fenced sub-group, will be distributed to RBSG. This will separate the ring-fenced sub-group from the non-ring-fenced entities, as required by the ring-fencing legislation.

January 2019

Once the RFTS, other restructuring and the ring-fencing legislation is in force:

Ring-fenced activities

- RBS plc (former Adam) will manage the RBS branded banking business in its UK branch network;
- NatWest will continue to manage NatWest branded banking business and its branch network in the UK and Western Europe;
- NatWest will operate as the shared service provider to the rest of the Group and will act as the market-facing arm for the ring-fenced banking group's payments and hedging activities;
- Adam will continue to be a trading name of RBS plc (former Adam) and will continue to operate its private banking and wealth management activities;
- Coutts & Company will continue its private banking and wealth management activities; and
- Ulster Bank Limited and Ulster Bank Ireland DAC will continue to operate in Northern Ireland and the Republic of Ireland respectively.

Non-ring-fenced activities

- NatWest Markets Plc (former RBS plc) will continue to undertake RBS's trading and investment banking activities; and
- RBS International Limited (RBSI), along with Isle of Man Bank, will continue to serve the markets and customers it serves today. In addition, RBSI becomes the focal point for funds banking activity through its recently opened London branch.

Report of the directors

Segmental reporting

Segmental reorganisation and business transfers

RBS continues to deliver on its plan to build a strong, simple and fair bank for both customers and shareholders. To support this, and in preparation for the UK ring-fencing regime, the previously reported operating segments were realigned in Q4 2017 and a number of business transfers completed.

Segmental reorganisation

The previously reported operating segments are now realigned and comparatives have been re-presented as follows:

- The former Williams & Glyn reportable operating segment has been integrated into the UK PBB reportable segment;
- The former Capital Resolution reportable operating segment has been integrated into the NatWest Markets reportable segment, with the exception of the costs in relation to the RMBS claims, which have been transferred to the Central & Other items reportable segment; and
- The RBSI reportable operating segment is no longer presented within the CPB franchise.

Business transfers

On 1 October 2017 the following changes were made to RBS's businesses, which impacts its financial reporting but where comparatives have not been re-presented:

- Shipping and other activities, which were formerly in Capital Resolution, were transferred from the NatWest Markets reportable segment to the Commercial Banking reportable segment.
- UK PBB Collective Investment Funds (CIFL) business was transferred to the Private Banking reportable segment in order to better serve customers.
- The RBS International (RBSI) reportable operating segment was aligned to the legal entity The Royal Bank of Scotland International (Holdings) Limited. This predominantly involved transfers from Private Banking, and Services and Functions within Central items & other in preparation for the implementation of the UK ring-fencing regime.
- Commercial Banking whole business securitisations and relevant financial institutions (RFI) were transferred to NatWest Markets during December 2017. RFIs are prohibited from being within the ring-fence due to their nature and exposure to global financial markets. The move is in preparation for the implementation of the UK ring-fencing regime.

Reportable operating segments

Following the changes detailed the reportable operating segments are as follows:

Personal & Business Banking (PBB) comprises two reportable segments: UK Personal & Business Banking (UK PBB) and Ulster Bank RoI. UK PBB serves individuals and mass affluent customers in the UK together with small businesses (generally up to £2 million turnover). UK PBB includes Ulster Bank customers in Northern Ireland. Ulster Bank RoI serves individuals and businesses in the Republic of Ireland (RoI).

Commercial & Private Banking (CPB) comprises two reportable segments: Commercial Banking and Private Banking. Commercial Banking serves commercial and corporate customers in the UK and Western Europe. Private Banking serves UK connected high net worth individuals.

RBS International (RBSI) serves retail, commercial, corporate and financial institution customers in Jersey, Guernsey, Isle of Man and Gibraltar and financial institution customers in Luxembourg and London.

NatWest Markets offers corporate and institutional customers global market access, providing them with trading, risk management and financing solutions through its trading and sales operations in London, Singapore and Stamford and sales offices in Dublin, Hong Kong and Tokyo.

Central items & other includes corporate functions, such as RBS treasury, finance, risk management, compliance, legal, communications and human resources. Central functions manages RBS capital resources and RBS-wide regulatory projects and provides services to the reportable segments. Balances in relation to legacy litigation issues and the international private banking business are included in the relevant periods.

Allocation of central balance sheet items

RBS allocates all central costs relating to Services and Functions to the business using appropriate drivers, these are reported as indirect costs in the segmental income statements. Assets (and risk-weighted assets) held centrally, mainly relating to RBS Treasury, are allocated to the business using appropriate drivers.

Results and dividends

The profit attributable to the ordinary shareholders of the Group for the year ended 31 December 2017 amounted to £752 million compared with a loss of £6,955 million for the year ended 31 December 2016, as set out in the consolidated income statement on page 235.

The company did not pay a dividend on ordinary shares in 2015, 2016 or 2017.

In the context of prior macro-prudential policy discussions, the Board decided to partially neutralise any impact on Core Tier 1 capital of coupon and dividend payments in respect of 2016 and 2017 Group hybrid capital instruments through equity issuances of c. £300 million. Consequently, approximately £300 million was raised each year in 2016 and 2017 through the issue of new ordinary shares and the Board has decided a further £300 million of new equity will be issued during the course of 2018 to again partially neutralise the CET1 impact of coupon and dividend payments.

Report of the directors

Business review

Activities

RBS is engaged principally in providing a wide range of banking and other financial services. Further details of the organisational structure and business overview of RBS, including the products and services provided by each of its operating segments and the markets in which they operate are contained in the Business review on pages 116 to 150. Details of the strategy for delivering the company's objectives can be found in the Strategic report.

Risk factors

RBS's future performance and results could be materially different from expected results depending on the outcome of certain potential risks and uncertainties. Full details of these and other risk factors are set out on pages 349 to 379.

The reported results of RBS are also sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. Details of RBS's critical accounting policies and key sources of accounting judgments are included in Accounting policies on pages 242 to 254.

RBS's approach to risk management, including its financial risk management objectives and policies and information on RBS's exposure to market, credit, liquidity and funding risk, is discussed in the Capital and risk management section.

Financial performance

A review of RBS's performance during the year ended 31 December 2017, including details of each operating segment, and RBS's financial position as at that date is contained in the Business review on pages 116 to 150.

RBS Holdings N.V. (formerly ABN AMRO Holding N.V.)

In 2017 NatWest Markets announced its plan to repurpose the existing licence in the Netherlands. This proposed approach should minimise disruption to the business and allow it to continue to serve customers in the event of any loss of EU passporting, as a result of the UK's departure from the EU. NatWest Markets and RBS N.V. are working together to ensure the banking licence is maintained and the entity is made operationally ready. In parallel, work continues to decrease the RBS N.V. legacy assets and liabilities further.

Business divestments

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Following the change of terms in respect of the business previously described as Williams & Glyn and agreed with the European Commission in September 2017, RBS will make a £425 million contribution to a Capability and Innovation Fund to be established to support competition in UK SME banking. The agreed alternative remedy package also requires a £350 million Incentivised Switching Scheme which will provide funding for eligible challenger bodies to help them incentivise SME customers to switch their accounts and loans from RBS. Should the uptake within the Incentivised Switching Scheme not be sufficient, RBS may be required to make a further contribution, capped at £50 million.

HMT is establishing an Independent Body to administer the Capability and Innovation fund and oversee and control the incentivised switching scheme. Once established the Independent Body, HMT and RBS will enter into the Framework Agreement Deed and fund the remedies.

Employees

Our colleagues

As at 31 December 2017, RBS employed 71,200 people (full-time equivalent basis, including temporary workers) throughout the world. Details of related costs are included in Note 3 on the consolidated accounts. The Board has considered ring-fencing preparations during the year and in advance of the legislation taking effect on 1 January 2019.

Engaging our colleagues is critical to delivering on our strategy and ambition as a bank. Further details on our approach can be found on page 34 and 35 of the strategic report.

Building a healthy culture

Building a healthy culture that embodies Our Values is one of RBS's core priorities.

Our Values guide the way RBS identify the right people to serve our customers well, and how RBS manage, engage and reward colleagues. They are at the heart of both Our Standards (the bank wide behavioural framework) and Our Code (the bank wide Code of Conduct).

Engaging our colleagues

RBS know that building an engaged, healthy and inclusive workforce is crucial to achieving our ambition. Every year RBS asks colleagues to share their thoughts on what it's like to work here via our annual colleague survey.

The 2017 results were the most positive we've seen in recent times. Key measures of engagement, leadership and our culture have improved significantly, and RBS are now above the global financial services norm in the majority of our survey categories.

Rewarding our colleagues

RBS's approach to performance management provides clarity for our colleagues about how their contribution links to our ambition. It recognises behaviour that supports our values and holds individuals to account for behaviour and performance that does not.

RBS have a focus on paying the right wage to colleagues and the RBS rates of pay continue to exceed the Living Wage Foundation Benchmarks.

Developing our colleagues

RBS continued to deliver Determined to Lead which is the core management system for the bank. It provides consistent tools to lead and engage colleagues. This programme has continued in 2017 with over 3,000 leaders participating.

In 2017 we launched the next stage in Service Excellence training, our customer service programme and had over 16,000 colleagues complete Level one.

Report of the directors

Professionalising colleagues is important to RBS. We continue to work closely with the Chartered Banker Institute (CBI) and Chartered Banker Professional Standards Board (CB:PSB) to offer RBS colleagues professional qualifications. In 2017 over 3,000 of colleagues completed their CBI qualification and 94% achieved the CB:PSB Foundation Standard.

RBS also offer a wide range of additional learning opportunities.

Youth Employment

In 2017, we welcomed 471 people across the RBS Graduate and Apprenticeship schemes as well as around 150 Summer Interns.

Health and wellbeing of our colleagues

Wellbeing is a strong foundation for making RBS a great place to work. For the third year running RBS participated in the Global Challenge (formerly GCC) and with 34,000 colleagues taking part we won the Global Challenge 1st Most Active Organisation Financial Industry. Building on this success, we embraced the rapid acceleration of digital wellbeing and are one of the few large organisations to pilot a digital wellbeing platform.

During 2017 RBS has continued to support Time to Change (removing the stigma of mental health) and actively encouraged open dialogue across the bank to support Mental Health in the Workplace. RBS were successful in running bankwide major online campaigns to support Mental Health Awareness Week and World Mental Health Day.

As RBS continue to support our colleagues through change we have fully utilised the services of our Employee Assistance Programme.

Employee consultation

RBS recognise employee representatives such as trade unions and work councils in a number of businesses and countries. There has been ongoing engagement and discussion with those bodies given the scale of change taking place across RBS. Management have continued to meet regularly with our European Employee Council to discuss developments and update on the progress of our strategic plans.

Inclusion

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Building a more inclusive RBS is essential for our customers and colleagues. Our inclusion policy standard applies to all colleagues globally.

During 2017, RBS continued to roll out unconscious bias learning to all colleagues (over 70,000 trained, to date) to create a solid platform for the wider inclusion agenda.

RBS continue to work towards our goal of having at least 30% senior women in our top three leadership layers across each Franchise and Function by 2020 and to be fully gender balanced (50/50) by 2030. We have a positive action approach in place, tailored by business, according to the specific challenges they face.

The RBS disability plan for training, career development and promotion of disabled persons employed by the company will support us becoming a disability smart organisation, with upper quartile performance, by 2018.

We continue to focus on building an ethnically diverse RBS. We will introduce explicit targets for BAME representation at senior levels in 2018.

Our LGBTQ agenda continues to deliver a better experience for our LGBTQ colleagues and customers. RBS have processes in place to support updating gender and title on customers' banking records and to support colleagues undergoing gender transition.

RBS have been recognised for our work on Equality, Diversity and Inclusion by retaining our Platinum ranking from Opportunity Now (gender), retaining our Gold ranking for Race for Opportunity (race); retaining a position in the Times Top 50 Employers for Women; becoming a Top Global Employer in Stonewall's Global Equality Index (LGBT), Silver Status from The Business Disability Forum and being rated a Top 10 Employer by Working Families. In 2017 we were proud to be named 'Diverse Company of the Year' at the National Diversity Awards and winning Workplace Adjustments Innovation of the Year at the Disability Smart Awards. RBS continue to support our c.20,000 strong employee-led networks.

Sustainability

The Sustainable Banking Committee's role is to support the Board in overseeing, supporting and challenging actions being taken by management to run RBS as a sustainable business.

For more information on our approach and progress please read the RBS Strategic Report included herein.

Greenhouse gas emissions

Disclosures relating to greenhouse gas emissions are included in the Strategic Report. These form part of the metrics and targets of the RBS climate change strategy. This is reported in accordance with the recommendations from the Financial Stability Boards Task Force on Climate-related Financial Disclosures (TCFD) on page 380. The RBS climate change strategy is driven by a range of external and internal drivers with oversight of climate related risks and opportunities through the Sustainable Banking Committee.

Going concern

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RBS's business activities and financial position, the factors likely to affect its future development and performance and its objectives and policies in managing the financial risks to which it is exposed and its capital are discussed in the Business review. The risk factors which could materially affect RBS's future results are set out on pages 349 to 379. RBS's regulatory capital resources and significant developments in 2017 and anticipated future developments are detailed in the Capital, liquidity and funding section on pages 163 to 178. This section also describes RBS's funding and liquidity profile, including changes in key metrics and the build up of liquidity reserves.

Report of the directors

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

BBA disclosure code

RBS's 2017 financial statements have been prepared in compliance with the principles set out in the Code for Financial Reporting Disclosure published by the British Bankers' Association in 2010. The Code sets out five disclosure principles together with supporting guidance. The principles are that RBS and other major UK banks will provide high quality, meaningful and decision-useful disclosures; review and enhance their financial instrument disclosures for key areas of interest to market participants; assess the applicability and relevance of good practice recommendations to their disclosures acknowledging the importance of such guidance; seek to enhance the comparability of financial statement disclosures across the UK banking sector; and clearly differentiate in their annual reports between information that is audited and information that is unaudited.

Enhanced Disclosure Task Force (EDTF)

The EDTF established by the Financial Stability Board, published its report *Enhancing the Risk Disclosures of Banks* in October 2012. All EDTF recommendations are reflected in the 2017 Annual Report on Form 20-F and Pillar 3 Report.

Corporate governance

The company is committed to high standards of corporate governance. Details are given in the Corporate governance report on pages 50 to 105. The Corporate governance report and compliance report (pages 106 to 107) form part of this Report of the directors.

Share capital

Details of the ordinary and preference share capital at 31 December 2017 and movements during the year are shown in Note 25 on the consolidated accounts.

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During 2017, the company allotted and issued a total of 119 million new ordinary shares of £1 each for the purposes of ensuring 2017 coupon payments on discretionary hybrid capital securities were partly neutralised from a Core Tier 1 capital perspective.

The shares were allotted to UBS AG at the subscription prices determined by reference to the average market prices during the sale periods set out below.

Number of shares sold	Subscription price	Sale period	Gross proceeds	Share price on allotment
33,376,695	239.6882	24/2/17 - 24/4/17	£80 million	249.3p
29,000,000	259.0457	28/4/17 - 30/6/17	£75 million	247.2p
56,634,740	256.0266	04/8/17 - 27/9/17	£145 million	270.8p

In the three years to 31 December 2017, the percentage increase in issued share capital due to non-pre-emptive issuance (excluding employee share schemes) for cash was 2.94%. In addition the company issued 22 million new ordinary shares in connection with employee share schemes in 2017.

In October 2015, HMT converted its entire holding of 51 billion B shares into 5.1 billion new ordinary shares of £1 each.

In March 2016, the company paid a final dividend of £1.2 billion in respect of the Dividend Access Share (DAS) held by HMT, effecting the immediate retirement of the DAS which was redesignated as a single B share and subsequently cancelled.

Authority to repurchase shares

At the Annual General Meeting in 2017 shareholders authorised the company to make market purchases of up to 1,184,237,107 ordinary shares. The directors have not exercised this authority to date. Shareholders will be asked to renew this authorisation at the Annual General Meeting in 2018.

Additional information

Where not provided elsewhere in the Report of the directors, the following additional information is required to be disclosed by Part 6 of Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

The rights and obligations attached to the company's ordinary shares and preference shares are set out in the company's Articles of Association, copies of which can be obtained from Companies House in the UK or can be found at rbs.com/about/board-and-governance.

On a show of hands at a general meeting of the company every holder of ordinary shares and cumulative preference shares present in person or by proxy and entitled to vote shall have one vote. On a poll, every holder of ordinary shares or cumulative preference shares present in person or by proxy and entitled to vote shall have four votes for every share held. The notices of Annual General Meetings and General Meetings specify the deadlines for exercising voting rights and appointing a proxy or proxies to vote in relation to resolutions to be passed at the meeting.

The cumulative preference shares represent less than 0.008% of the total voting rights of the company, the remainder being represented by the ordinary shares.

Report of the directors

There are no restrictions on the transfer of ordinary shares in the company other than certain restrictions which may from time to time be imposed by laws and regulations (for example, insider trading laws).

Pursuant to the Listing Rules of the FCA, certain employees of the company require the approval of the company to deal in the company's shares.

The rules governing the powers of directors, including in relation to issuing or buying back shares and their appointment are set out in the company's Articles of Association. It will be proposed at the 2018 Annual General Meeting that the directors be granted authorities to allot shares under the Companies Act 2006. The company's Articles of Association may only be amended by a special resolution at a general meeting of shareholders.

The rights and obligations of holders of non-cumulative preference shares are set out in Note 25 on the consolidated accounts.

The company is not aware of any agreements between shareholders that may result in restrictions on the transfer of securities and/or voting rights. There are no persons holding securities carrying special rights with regard to control of the company. A number of the company's employee share plans include restrictions on transfers of shares while shares are subject to the plans or the terms under which the shares were awarded.

Under the rules of certain employee share plans, eligible employees are entitled to acquire shares in the company, and shares are held in trust for participants by The Royal Bank of Scotland plc as Trustees. Voting rights are exercised by the Trustees on receipt of participants' instructions. If a participant does not submit an instruction to the Trustee no vote is registered.

The Royal Bank of Scotland Group plc 2001 Employee Share Trust and The Royal Bank of Scotland Group plc 2007 US Employee Share Trust hold shares on behalf of RBS's employee share plans. The voting rights are exercisable by the Trustees, however, in accordance with investor protection guidelines, the Trustees abstain from voting. The Trustees would take independent advice before accepting any offer in respect of their shareholdings for the company in a takeover bid situation.

Awards granted under the company's employee share plans may be met through a combination of newly issued shares and shares acquired in the market by the company's employee benefit trusts.

A change of control of the company following a takeover bid may cause a number of agreements to which the company is party to take effect, alter or terminate. All of the company's employee share plans contain provisions relating to a change of control. Outstanding awards and options may

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vest and become exercisable on change of control, subject where appropriate to the satisfaction of any performance conditions at that time and pro-rating of awards. In the context of the company as a whole, these agreements are not considered to be significant.

Directors

The names and brief biographical details of the current directors are shown on pages 50 to 55.

Howard Davies, Frank Dangeard, Alison Davis, Morten Friis, Robert Gillespie, Penny Hughes, Ross McEwan, Brendan Nelson, Baroness Noakes, Mike Rogers and Ewen Stevenson all served throughout the year and to the date of signing of the financial statements.

Mark Seligman was appointed on 1 April 2017. Yasmin Jetha was appointed 21 June 2017 and Dr Lena Wilson was appointed on 1 January 2018.

All directors of the company are required to stand for election or re-election annually by shareholders at the Annual General Meeting and, in accordance with the UK Listing Rules, the election or re-election of independent directors requires approval by all shareholders and also by independent shareholders.

Directors interests

The interests of the directors in the shares of the company at 31 December 2017 are shown on page 97. None of the directors held an interest in the loan capital of the company or in the shares or loan capital of any of the subsidiary undertakings of the company, during the period from 1 January 2017 to 22 February 2018.

Directors indemnities

In terms of section 236 of the Companies Act 2006 (the Companies Act), Qualifying Third Party Indemnity Provisions have been issued by the company to its directors, members of the RBS Executive Committee, individuals authorised by the PRA/FCA and certain directors and/or officers of RBS subsidiaries.

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

Post balance sheet events

Other than the matter disclosed on page 324, there have been no significant events between the year end and the date of approval of these accounts which would require a change to or disclosure in the accounts.

Controlling shareholder

In accordance with the UK Listing Rules, the company has entered into an agreement with HM Treasury (the Controlling Shareholder) which is intended to ensure that the Controlling Shareholder complies with the independence provisions set out in the UK Listing Rules. The company has complied with the independence provisions in the relationship agreement and as far as the company is aware the independence and procurement provisions in the relationship agreement have been complied with in the period by the controlling shareholder.

Report of the directors

Shareholdings

The table below shows shareholders that have notified RBS that they hold more than 3% of the total voting rights of the company at 31 December 2017.

	Number of shares (millions)	% of share class held	% of total voting rights held
Solicitor For The Affairs of Her Majesty's Treasury as Nominee for Her Majesty's Treasury Ordinary shares	8,434	70.5	70.5

As at 22 February 2018, there were no changes to the shareholdings shown in the table above.

Listing Rule 9.8.4

In accordance with the UK Financial Conduct Authority's Listing Rules the information to be included in the Annual Report and Accounts under LR 9.8.4, is set out in this Directors' report with the exception of details of contracts of significance under LR 9.8.4. (10) and (11) given in Additional Information on pages 346 and 347.

Political donations

At the Annual General Meeting in 2017, shareholders gave authority under Part 14 of the Companies Act, for a period of one year, for the company (and its subsidiaries) to make political donations and incur political expenditure up to a maximum aggregate sum of £100,000. This authorisation was taken as a precaution only, as the company has a longstanding policy of not making political donations or incurring political expenditure within the ordinary meaning of those words. During 2017, RBS made no political donations, nor incurred any political expenditure in the UK or EU and it is not proposed that RBS's longstanding policy of not making contributions to any political party be changed. Shareholders will be asked to renew this authorisation at the Annual General Meeting in 2018.

Directors' disclosure to auditors

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Each of the directors at the date of approval of this report confirms that:

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

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

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

Auditors

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

By order of the Board

Aileen Taylor

Company Secretary

22 February 2018

The Royal Bank of Scotland Group plc

is registered in Scotland No. SC45551

Statement of directors responsibilities

This statement should be read in conjunction with the responsibilities of the auditor set out in their report on pages 232 to 234.

The directors are responsible for the preparation of the Annual Report and Accounts. The directors are required by Article 4 of the IAS Regulation (European Commission Regulation No 1606/2002) to prepare Group accounts, and as permitted by the Companies Act 2006 have elected to prepare company accounts, for each financial year in accordance with International Financial Reporting Standards as adopted by the European Union. They are responsible for preparing accounts that present fairly the financial position, financial performance and cash flows of the Group and the 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 2006. They are also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors confirm that to the best of their knowledge:

- the financial statements, prepared in accordance with International Financial Reporting Standards as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit or loss of the company and the undertakings included in the consolidation taken as a whole; and
- the Strategic Report and Directors report (incorporating the Business review) include a fair review of the development and performance of the business and the position of the company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

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In addition, the directors are of the opinion that the Annual Report and Accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy.

By order of the Board

Howard Davies
Chairman

Ross McEwan
Chief Executive

Ewen Stevenson
Chief Financial Officer

22 February 2018

Board of directors

Chairman
Howard Davies

Executive directors
Ross McEwan

Ewen Stevenson

Non-executive directors
Frank Dangeard

Alison Davis

Morten Friis

Robert Gillespie

Penny Hughes

Yasmin Jetha

Brendan Nelson

Baroness Noakes

Mike Rogers

Mark Seligman

Dr Lena Wilson

Business Review

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Presentation of information

Segmental reporting

RBS continues to deliver on its plan to build a strong, simple and fair bank for both customers and shareholders. To support this, and in preparation for the UK ring-fencing regime, the previously reported operating segments were realigned in Q4 2017 and a number of business transfers completed, for full details see the Report of the directors.

Reportable operating segments

Following the Q4 2017 changes the reportable operating segments are as follows, for full business descriptions see page 109 of the Report of the directors and Note 37 on the accounts:

Franchise Personal & Business Banking (PBB)	Reportable operating segment UK Personal & Business Banking (UK PBB)
Commercial & Private Banking (CPB)	Ulster Bank RoI Commercial Banking Private Banking
Other reportable segments	RBS International (RBSI) NatWest Markets Central items & other

Allocation of central balance sheet items

RBS allocates all central costs relating to Services and Functions to the business using appropriate drivers, these are reported as indirect costs in the segmental income statements. Assets (and risk-weighted assets) held centrally, mainly relating to RBS Treasury, are allocated to the business using appropriate drivers.

RBS Group ring-fencing

The UK ring-fencing legislation requiring the separation of essential banking services from investment banking services will take effect from 1 January 2019.

To comply with these requirements it is RBS's intention to place the majority of the UK and Western European banking business in ring-fenced banking entities under an intermediate holding company. NatWest Markets Plc (NatWest Markets) will be a separate non ring-fenced bank and The Royal Bank of Scotland International (Holdings) Limited (RBSI Holdings) will also be placed outside the ring-fence, both as direct subsidiaries of RBSG.

On 1 January 2017, RBS made a number of key changes to the legal hierarchy of its subsidiaries to support the move towards a ring-fenced structure. As part of continuing preparation to deliver a fully compliant ring-fencing structure by 1 January 2019, it plans to undertake a further series of actions. For further details of these actions see the Report of the directors.

Business divestments

Citizens

RBS sold the final tranche of its interest in Citizens Financial Group, Inc. during the second half of 2015. Consequently, Citizens was classified as a disposal group at 31 December 2014 and presented as a discontinued operation until October 2015. From 3 August 2015 until the final tranche was sold in October 2015, Citizens was an associated undertaking.

Business review

Competition

Personal & Business Banking (comprising UK PBB and Ulster Bank Rol)

In the personal and small business banking business, RBS competes with a range of providers including UK banks and building societies, major retailers and life assurance companies, as well as the UK subsidiaries of major international banks. In the mortgage market, RBS competes with UK banks, building societies and specialist lenders. Increasingly, the ambitions of non-traditional players in the UK market are gaining credibility, with new entrants active and seeking to build their platforms either through organic growth or in some cases by acquiring businesses made available through the restructuring of incumbents. Entrants with new business models such as peer-to-peer lending platforms, while currently small, continue to grow rapidly and are emerging as significant competitors. Such competitors often target specific elements of the value chain, providing specialised services to particular customer segments.

RBS distributes life assurance products to banking customers in competition with independent advisors and life assurance companies.

In Ireland, Ulster Bank competes in retail and commercial banking with the major Irish banks and building societies, and with other UK and international banks and building societies active in the market.

In the UK credit card market large retailers and specialist card issuers are active in addition to the UK banks. In addition to physical distribution channels, providers compete through direct marketing activity and digital channels.

In an environment in which central banks have maintained very low interest rates for an unusually long period or introduced negative rates, competitive dynamics have changed in some of the principal markets in which RBS operate. Although the interest rate outlook is beginning to change, with many central banks pointing to interest rate rises in the coming years. Other key competitive factors in this market segment include cost management, growing digital sales focus, branch network re-shaping, and product simplification. Cost management remains a key focus in the market, as banks seek to simplify their organisational and IT architectures while at the same time investing to ensure that they can meet customers' evolving channel preferences. Customers have increasingly focused on the use of internet and mobile as sales and service channels for certain types of products. Therefore, competitive position and performance in the sector increasingly depends on the possession of user-friendly, diverse and efficient online solutions.

Although conveniently located branches are still important, RBS faces competitive pressure to adjust its branch formats to meet changing customer expectations and to manage its branch footprint as over-the-counter transaction volumes decline. In terms of product offering, the industry trend is to limit the number of products and present the product structure and costs in a clear and transparent manner.

Commercial & Private Banking (comprising Commercial Banking and Private Banking)

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Competition for corporate and institutional customers in the UK is from UK banks, from specialised global and regional investment banks and from large foreign universal banks that offer combined investment and commercial banking capabilities as well as from new entrants and non-bank challengers. In asset finance and invoice finance, RBS competes with banks and specialist finance providers, both captive and non-captive. In the small business banking market, RBS competes with other UK banks, specialist finance providers and building societies. In all of these areas, entrants with new technology-based business model are also showing rapid growth. Coutts and Adam & Company compete as private banks with UK clearing and private banks, asset managers and with international private banks. Competition in wealth management remains strong as banks maintain their focus on competing for affluent and high net worth customers.

NatWest Markets

NatWest Markets offers corporate and institutional customers global market access, providing them with trading, risk management and financing solutions through its trading and sales operations in London, Singapore and Stamford and sales offices in Dublin, Hong Kong and Tokyo. NatWest Markets therefore competes with large domestic banks, major international banks and a number of investment banks that offer such products in these regions.

RBS product proposition is built around our core strengths: supporting customers across currencies, rates and financing. Key competitive factors in this market include the ability to develop automation across flow products as well as delivering value-adding bespoke solutions for our customers.

With an evolving regulatory landscape and continued pressure on margins, competition in this market remains strong. Many market participants are also revising their strategy in order to ensure they deliver sustainable returns.

RBS International

RBS International competes with other UK and international banks to offer offshore banking services as well as domestic banking services in the Channel Islands, Gibraltar and the Isle of Man. RBSI also supports financial institution customers through wholesale branches in Luxembourg and London, both opened in 2017.

Business review

Consolidated income statement for the year ended 31 December 2017

	2017 £m	2016 £m	2015 £m
Interest receivable	11,034	11,258	11,925
Interest payable	(2,047)	(2,550)	(3,158)
Net interest income	8,987	8,708	8,767
Fees and commissions receivable	3,338	3,340	3,742
Fees and commissions payable	(883)	(805)	(809)
Income from trading activities	634	974	1,060
Loss on redemption of own debt	(7)	(126)	(263)
Other operating income	1,064	499	426
Non-interest income	4,146	3,882	4,156
Total income	13,133	12,590	12,923
Staff costs	(4,676)	(5,124)	(5,726)
Premises and equipment	(1,565)	(1,388)	(1,827)
Other administrative expenses	(3,323)	(8,745)	(6,288)
Depreciation and amortisation	(808)	(778)	(1,180)
Write down of goodwill and other intangible assets	(29)	(159)	(1,332)
Operating expenses	(10,401)	(16,194)	(16,353)
Profit/(loss) before impairment (losses)/releases	2,732	(3,604)	(3,430)
Impairment (losses)/releases	(493)	(478)	727
Operating profit/(loss) before tax	2,239	(4,082)	(2,703)
Tax charge	(824)	(1,166)	(23)
Profit/(loss) from continuing operations	1,415	(5,248)	(2,726)
Profit from discontinued operations, net of tax			1,541
Profit/(loss) for the year	1,415	(5,248)	(1,185)
Attributable to:			
Non-controlling interests	35	10	409
Preference shareholders	234	260	297
Paid-in equity holders	394	244	88
Dividend access share		1,193	
Ordinary shareholders	752	(6,955)	(1,979)
	1,415	(5,248)	(1,185)
Memo:			
Total income - adjusted (1,3)	12,862	12,372	13,034
Operating expenses - adjusted (2,3)	(7,551)	(8,220)	(9,356)
Operating profit - adjusted (1,2,3)	4,818	3,674	4,405

Notes:

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- (1) Excluding own credit adjustments, loss on redemption of own debt and strategic disposals. Tax on these items was a £24 million charge in 2017 (2016 - £90 million charge; 2015 - £15 million charge).
- (2) Excluding restructuring costs, litigation and conduct costs and write down of goodwill. Tax on these items was £369 million in 2017 (2016 - £286 million; 2015 - £563 million).
- (3) See the following page for segmental income statement reconciliation.

Business review

Analysis of results

Segmental summary income statements

	PBB		CPB				Central items & other £m	Total RBS £m
	UK	Ulster Bank	Commercial Banking £m	Private Banking International £m	RBS £m	NatWest Markets £m		
	PBB £m	RoI £m						
2017								
Total income - adjusted	6,477	607	3,484	678	389	1,090	137	12,862
Own credit adjustments		(3)				(66)		(69)
Loss on redemption of own debt							(7)	(7)
Strategic disposals						26	321	347
Total income	6,477	604	3,484	678	389	1,050	451	13,133
Operating expenses - adjusted	(3,158)	(451)	(1,814)	(445)	(202)	(1,528)	47	(7,551)
Restructuring costs	(461)	(56)	(167)	(45)	(9)	(436)	(391)	(1,565)
Litigation and conduct costs	(210)	(169)	(33)	(39)	(8)	(237)	(589)	(1,285)
Operating expenses	(3,829)	(676)	(2,014)	(529)	(219)	(2,201)	(933)	(10,401)
Impairment (losses)/releases	(235)	(60)	(362)	(6)	(3)	174	(1)	(493)
Operating profit/(loss) - adjusted	3,084	96	1,308	227	184	(264)	183	4,818
Operating profit/(loss)	2,413	(132)	1,108	143	167	(977)	(483)	2,239
Return on equity (1)	23.7%	(5.0%)	6.6%	6.4%	11.2%	(9.0%)	nm	2.2%
Return on equity - adjusted (1,2)	30.7%	3.6%	8.2%	11.3%	12.6%	(3.7%)	nm	8.8%
Cost income ratio (3)	59.1%	111.9%	56.0%	78.0%	56.3%	nm	nm	79.0%
Cost income ratio - adjusted (2,3)	48.8%	74.3%	50.0%	65.6%	51.9%	140.2%	nm	58.2%
2016								
Total income - adjusted	6,127	573	3,415	657	374	1,106	120	12,372
Own credit adjustments		3				187	(10)	180
Loss on redemption of own debt							(126)	(126)
Strategic disposals						(81)	245	164
Total income	6,127	576	3,415	657	374	1,212	229	12,590
Operating expenses - adjusted	(3,398)	(457)	(1,936)	(511)	(169)	(2,084)	335	(8,220)
Restructuring costs	(244)	(40)	(108)	(37)	(5)	(190)	(1,482)	(2,106)
Litigation and conduct costs	(634)	(172)	(423)	(1)		(550)	(4,088)	(5,868)
Operating expenses	(4,276)	(669)	(2,467)	(549)	(174)	(2,824)	(5,235)	(16,194)
Impairment (losses)/releases	(125)	113	(206)	3	(10)	(253)		(478)
Operating profit/(loss) - adjusted	2,604	229	1,273	149	195	(1,231)	455	3,674
Operating profit/(loss)	1,726	20	742	111	190	(1,865)	(5,006)	(4,082)
Return on equity (1)	16.2%	0.7%	4.1%	5.6%	13.8%	(12.5%)	nm	(17.9%)
Return on equity - adjusted (1,2)	25.1%	8.4%	8.4%	7.8%	14.2%	(8.7%)	nm	1.6%

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Cost income ratio (3)	69.8%	116.1%	71.0%	83.6%	46.5%	nm	nm	129.0%
Cost income ratio - adjusted (2,3)	55.5%	79.8%	54.8%	77.8%	45.2%	188.4%	nm	66.0%
2015								
Total income - adjusted	6,033	550	3,254	644	367	1,809	377	13,034
Own credit adjustments						295	14	309
Loss on redemption of own debt							(263)	(263)
Strategic disposals						(38)	(119)	(157)
Total income	6,033	550	3,254	644	367	2,066	9	12,923
Operating expenses - adjusted	(3,397)	(427)	(1,801)	(518)	(156)	(3,006)	(51)	(9,356)
Restructuring costs	(195)	(15)	(69)	(73)	(4)	(1,831)	(744)	(2,931)
Litigation and conduct costs	(972)	13	(51)	(12)		(404)	(2,142)	(3,568)
Write down of goodwill				(498)				(498)
Operating expenses	(4,564)	(429)	(1,921)	(1,101)	(160)	(5,241)	(2,937)	(16,353)
Impairment (losses)/releases	(8)	141	(69)	(13)		730	(54)	727
Operating profit/(loss) - adjusted	2,628	264	1,384	113	211	(467)	272	4,405
Operating profit/(loss)	1,461	262	1,264	(470)	207	(2,445)	(2,982)	(2,703)
Return on equity (1)	13.5%	10.6%	9.8%	(27.7%)	18.5%	(11.2%)	nm	(4.7%)
Return on equity - adjusted (1,2)	25.3%	10.6%	10.9%	4.9%	18.9%	(3.0%)	nm	11.0%
Cost income ratio (3)	75.7%	78.0%	57.2%	171.0%	43.6%	nm	nm	126.9%
Cost income ratio - adjusted (2,3)	56.3%	77.6%	53.3%	80.4%	42.5%	166.2%	nm	71.4%

Notes:

(1) RBS's CET 1 target is 13% but for the purposes of computing segmental return on equity (ROE), to better reflect the differential drivers of capital usage, segmental operating profit after tax and adjusted for preference dividends is divided by average notional equity allocated at different rates of 14% (Ulster Bank RoI - 11% prior to 2017), 11% (Commercial Banking), 14% (Private Banking - 15% prior to 2017), 16% (RBS International - 12% prior to November 2017) and 15% for all other segments, of the monthly average of segmental risk-weighted assets incorporating the effect of capital deductions (RWAs). Return on equity is calculated using profit for the period attributable to ordinary shareholders.

(2) Excluding own credit adjustments, (loss)/gain on redemption of own debt, strategic disposals, restructuring costs, litigation and conduct costs and write down of goodwill.

(3) Operating lease depreciation included in income (year ended December 2017 - £142 million; year ended 31 December 2016 - £152 million).

Business review

Analysis of results [continued](#)

Net interest income

	2017 £m	2016 £m	2015 £m
Interest receivable (1,2)	11,034	11,258	11,925
Interest payable (1,2)	(2,047)	(2,550)	(3,158)
Net interest income	8,987	8,708	8,767

Yields, spreads and margins of the banking business

	%	%	%
Gross yield on interest-earning assets of the banking business (3)	2.57	2.80	2.89
Cost of interest-bearing liabilities of the banking business	(0.70)	(0.95)	(1.14)
Interest spread of the banking business (4)	1.87	1.85	1.75
Benefit from interest-free funds	0.26	0.33	0.37
Net interest margin of the banking business (2,5)	2.13	2.18	2.12

Notes:

- (1) Negative interest on loans and advances is classed as interest payable and on customer deposits is classed as interest receivable.
- (2) Interest receivable and interest payable on trading assets and liabilities are included in income from trading activities.
- (3) Gross yield is the interest earned on average interest-earning assets of the banking book.
- (4) Interest spread is the difference between the gross yield and the interest rate paid on average interest-bearing liabilities of the banking business.
- (5) Net interest margin is net interest income of the banking business as a percentage of interest-earning assets (IEA) of the banking business.

2017 compared with 2016

Net interest income of £8,987 million increased by £279 million compared with 2016. The movement was principally driven by higher mortgage volumes in UK PBB, up £185 million or 3.7%, and deposit re-pricing benefits in Commercial Banking, up £143 million or 6.7%, partially offset by planned balance sheet reductions in NatWest Markets.

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The net interest margin (NIM) was 2.13% for 2017, 5 basis points lower than 2016 reflecting increased liquidity, mix impacts and competitive pressures on margin.

UK PBB NIM of 2.86% was 11 basis points lower than 2016 reflecting lower mortgage margins, asset mix and reduced current account hedge yield, partially offset by savings re-pricing benefits from actions taken in 2016 and following the Q4 2017 base rate increase.

Ulster Bank RoI NIM increased by 5 basis points to 1.67% driven by a combination of improved deposit and loan margins, one-off income adjustments and successful deleveraging measures in 2016 which have reduced the concentration of low yielding loans.

Commercial Banking NIM decreased by 2 basis points as active re-pricing of assets and deposits has been more than offset by asset margin pressure in a low rate environment.

Private Banking NIM decreased by 19 basis points to 2.47% reflecting the competitive market and low rate environment, partially offset by higher funding benefits on deposits following the Q4 2017 base rate increase.

RBSI NIM remained stable at 1.36% as active re-pricing of deposits has been offset by the low rate environment.

Structural hedges of £129 billion generated a benefit of £1.3 billion through net interest income for the year.

2016 compared with 2015

Net interest income of £8,708 million reduced by £59 million compared with 2015 principally driven by a £126 million reduction in legacy NatWest Markets business, in line with the planned shrinkage of the balance sheet.

NIM was 2.18% for 2016, 6 basis points higher than 2015 as the benefit associated with reductions in low yielding non-core assets has been partially offset by modest asset margin pressure and mix impacts across PBB (comprising the reportable segments UK PBB and Ulster Bank RoI), CPB (comprising the reportable segments Commercial Banking and Private Banking) and RBSI.

Average interest earning assets(1) across the combined PBB, CPB and RBSI increased by 10% on 2015, compared with a 3% decline for RBS total, and represented 88% of total average interest earning assets (2015 - 77%). NIM across PBB, CPB and RBSI was 2.34%, 13 basis points lower than 2015.

UK PBB NIM decreased by 16 basis points to 2.97% reflecting the impact of the overall portfolio mix being increasingly weighted towards secured lending and mortgage customers switching from standard variable rate (SVR) to lower rate products. During the second half of 2016 SVR balances stabilised at approximately 12% of mortgage balances. Ulster Bank RoI NIM increased by 5 basis points to 1.62% driven by a continued reduction in the cost of deposits and a reduced volume of low yielding liquid assets, partly offset by reduced income on free funds.

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Commercial Banking NIM fell by 12 basis points to 1.76% driven by asset margin pressure in a competitive market and low rate environment. Private Banking NIM reduced by 9 basis points to 2.66% principally driven by asset margin pressure. RBSI NIM fell by 12 basis points to 1.36% reflecting asset and liability margin pressures, partially offset by mitigating pricing actions.

Structural hedges of £123 billion generated a benefit of £1.3 billion through net interest income for the year. Around 73% of these hedges are part of a five year rolling hedge programme (with around 27% as part of a ten year hedge) that will progressively roll-off over the coming years.

Note:

(1) See table below for combined net interest income, average interest earning assets and NIM calculation.

Reportable segment	Net interest income		Average interest earning assets		NIM	
	2016	2015	2016	2015	2016	2015
UK PBB	4,945	4,810	166,778	153,642	2.97%	3.13%
Ulster Bank RoI	409	365	25,193	23,232	1.62%	1.57%
Commercial Banking	2,143	1,997	121,677	106,429	1.76%	1.88%
Private banking	449	436	16,887	15,835	2.66%	2.75%
RBSI	303	303	22,254	20,518	1.36%	1.48%
PBB, CPB & RBSI combined	8,249	7,911	352,789	319,656	2.34%	2.47%

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Non-interest income

The following table reconciles adjusted non-interest income (a non-GAAP financial measure) to the statutory basis.

	2017	2016	2015
	£m	£m	£m
Fees and commissions receivable - statutory basis	3,338	3,340	3,742
Fees and commissions payable - statutory basis	(883)	(805)	(809)
Own credit adjustments (1)			
- adjusted basis	(69)	180	309
- income from trading activities	69	(154)	(254)
- other non interest income		(26)	(55)
Statutory basis			
Income from trading activities			
- adjusted basis	703	820	806
- own credit adjustments	(69)	154	254
Statutory basis	634	974	1,060
(Loss)/gain on redemption of own debt - statutory basis	(7)	(126)	(263)
Strategic disposals (1)			
- adjusted basis	347	164	(157)
- other operating income	(347)	(164)	157
Statutory basis			
Other operating income			
- adjusted basis	717	309	528
- own credit adjustments		26	55
- strategic disposals	347	164	(157)
Statutory basis	1,064	499	426
Total non-interest income - adjusted basis	4,146	3,882	4,156
Total non-interest income - statutory basis	4,146	3,882	4,156

Note:

(1) Items reallocated to other income lines, not reconciling items.

Business review

2017 compared with 2016

Non-interest income of £4,146 million increased by £264 million, or 6.8%, compared with 2016, primarily reflecting a £185 million debt sale gain in UK PBB and a £183 million increase in strategic disposals gains, partially offset by an own credit adjustment loss of £69 million compared with a gain of £180 million in 2016.

Net fees and commissions decreased by £80 million, or 3.2%, compared with 2016 reflecting a £48 million reduction in UK PBB, driven by increased cash back payments as the Reward proposition continued to grow with customer accounts 26% higher than 2016, and lower income in NatWest Markets.

Income from trading activities decreased by £117 million, or 14.3%, compared with 2016 primarily reflecting lower income in NatWest Markets, down £247 million, or 29.8%, driven by increased losses in the legacy business. A gain of £2 million for volatile items under IFRS in 2017 compared with a charge of £510 million in 2016. This movement was broadly offset by FX losses of £183 million in 2017, compared with FX gains of £446 million in 2016, following the strengthening of sterling against the US dollar.

Other operating income increased by £408 million primarily reflecting increased NatWest Markets income and the debt sale gain in UK PBB.

2016 compared with 2015

Non-interest income was £3,882 million, a reduction of £274 million, or 6.6%, compared with 2015. The legacy NatWest Markets business non-interest income reduced by £775 million reflecting planned asset disposal, including £572 million of disposal losses compared with £367 million in 2015, and a funding valuation adjustment of £170 million. In addition, we recognised a charge of £510 million for volatile items under IFRS compared with a £15 million gain in 2015. Partially offsetting, we reported a strategic disposal gain of £164 million, compared with a loss of £157 million in 2015, a loss on redemption of own debt of £126 million, compared with £263 million in 2015, an FX gain of £349 million following the significant weakening of sterling against the dollar and a £97 million foreign exchange reserve recycling gain.

Net fees and commissions decreased by £398 million, or 13.6%, compared with 2015 reflecting the planned asset run-down in the legacy NatWest Markets business, £168 million, a reduction in NatWest Markets core business, £175 million, and a £33 million reduction in UK PBB, driven by lower credit card interchange fees and increased cash back payments following the launch of the Rewards account.

Income from trading activities increased by £14 million to £820 million as an £86 million increase in NatWest Markets income has been partially offset by an increased charge for volatile items under IFRS.

Other operating income reduced by £219 million principally reflecting planned asset disposals in the legacy NatWest Markets business.

Business review

Analysis of results [continued](#)

Operating expenses

The following table reconciles adjusted operating expenses (a non-GAAP financial measure) to the statutory basis.

	2017 £m	2016 £m	2015 £m
Staff costs			
- adjusted basis (1)	3,923	4,482	4,896
- restructuring costs	753	642	830
Statutory basis	4,676	5,124	5,726
Premises and equipment			
- adjusted basis (1)	1,218	1,297	1,483
- restructuring costs	347	91	344
Statutory basis	1,565	1,388	1,827
Other administrative expenses			
- adjusted basis (1)	1,710	1,619	2,124
- litigation and conduct costs	1,285	5,868	3,568
- restructuring costs	328	1,258	596
Statutory basis	3,323	8,745	6,288
Restructuring costs (2)			
- adjusted basis	1,565	2,106	2,931
- staff expenses	(753)	(642)	(830)
- premises and equipment	(347)	(91)	(344)
- other administrative expenses	(328)	(1,258)	(596)
- depreciation and amortisation	(124)	(73)	(402)
- write down of other intangible assets	(13)	(42)	(759)
Statutory basis			
Litigation and conduct costs (2)			
- adjusted basis	1,285	5,868	3,568
- other administrative expenses	(1,285)	(5,868)	(3,568)
Statutory basis			
Administrative expenses - non-statutory	9,701	15,372	15,002
Administrative expenses - statutory	9,564	15,257	13,841
Depreciation and amortisation			
- adjusted basis (1)	684	705	778
- restructuring costs	124	73	402
Statutory basis	808	778	1,180
Write down of goodwill (2)			
- adjusted basis			498
- write down of goodwill			(498)
Statutory basis			
Write down of other intangible assets			
- adjusted basis (1)	16	117	75
- write down of other intangible assets	(16)	(117)	(75)
Statutory basis			
Write-down of other goodwill and other intangible assets			

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- adjusted basis (1)			498
- write down of goodwill			75
- write off of intangible assets	16	117	75
- restructuring costs	13	42	759
Statutory basis	29	159	1,332
Operating expenses - adjusted basis	10,401	16,194	16,353
Operating expenses - statutory basis	10,401	16,194	16,353

Notes:

- (1) Adjusted basis is calculated as operating expenses before restructuring costs and litigation and conduct costs.
- (2) Items reallocated to other expense lines, not reconciling items.

Business review

2017 compared with 2016

Total operating expenses of £10,401 million were £5,793 million, or 35.8%, lower than 2016 reflecting a £4,583 million reduction in litigation and conduct costs, a £669 million, or 8.1%, reduction in adjusted operating expenses(1) which excludes a £541 million reduction in restructuring costs.

Excluding VAT recoveries of £86 million (2016 - £227 million), adjusted operating expenses(1) have reduced by £810 million for the year, ahead of our £750 million targeted reduction, with approximately 45% of the total cost reduction delivered across PBB (comprising the reportable segments UK PBB and Ulster Bank RoI), CPB (comprising the reportable segments Commercial Banking and Private Banking, RBSI and the NatWest Markets core business, adjusting for transfers.(1,2)

Staff costs of £3,923 million were £559 million, or 12.5%, lower than 2016 underpinned by a 6,600, or 8.5%, reduction in FTEs.

Restructuring costs of £1,565 million included: a £303 million charge relating to the reduction in the property portfolio; a £319 million charge in NatWest Markets principally relating to the run-down and closure of the legacy business; £221 million relating to the business previously described as Williams & Glyn; £194 million in respect of implementing ring-fencing requirements; and a £73 million net settlement relating to the RBS Netherlands pension scheme.

Litigation and conduct costs of £1,285 million included: additional charges in respect of settlement with Federal Housing Finance Agency (FHFA) and the California State Attorney General and additional RMBS related provisions in the US; a further provision in relation to settling the 2008 rights issue shareholder litigation; an additional £175 million PPI provision; and a £169 million provision in Ulster Bank RoI for customer remediation and project costs relating to tracker mortgages and other legacy business issues.

2016 compared with 2015

Operating expenses of £16,194 million were £159 million, or 1%, lower than 2015 reflecting a £1,136 million, or 12%, reduction in adjusted operating expenses(1) which excludes a £825 million, or 28%, reduction in restructuring costs. In addition, 2015 included a £498 million write down of goodwill relating to Private Banking. Partially offsetting the above, litigation and conduct costs increased by £2,300 million.

Adjusted operating expenses(1) reduced by £1,136 million, or 12%, compared with 2015 to £8,220 million. Excluding expenses associated with the business previously described as Williams & Glyn £393 million (2015 - £359 million), write down of intangibles £117 million (2015 - £75 million) and a £227 million VAT recovery, adjusted expenses(1) reduced by £985 million, or 11%, in excess of our £800 million target. RBS has achieved a cumulative cost reduction of £3.1 billion across 2014 - 2016.

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Staff costs of £5,124 million were £602 million, or 11%, lower than 2015 underpinned by a 13,700, or 15%, reduction in FTEs and a reduction in restructuring costs of £188 million, or 23% to £642 million.

Restructuring costs were £2,106 million for 2016, compared with £2,931 million in 2015, and included a £750 million provision in respect of the 17 February 2017 update on RBS's remaining State Aid obligation regarding the business previously described as Williams & Glyn. In addition, £706 million of the remaining restructuring costs relate to the business previously described as Williams & Glyn, including £146 million of termination costs associated with the decision to discontinue the programme to create a cloned banking platform.

Litigation and conduct costs of £5,868 million included; a £3,107 million provision in relation to various investigations and litigation matters relating to RBS's issuance and underwriting of residential mortgage-backed securities (RMBS), £601 million of additional PPI provisions, a £400 million provision in respect of the FCA review of RBS's treatment of SMEs, an additional £169 million charge in respect of the settlement with the National Credit Union Administration Board to resolve two outstanding RMBS lawsuits in the United States relating to residential mortgage backed securities, a £172 million provision in Ulster Bank RoI, principally in respect of remediation and programme costs associated with an industry wide examination of tracker mortgages, and a provision in respect of the UK 2008 rights issue shareholder litigation.

Notes:

- (1) Refer to income statement reconciliations on page 120.
- (2) Including the impact of transfers. See notes on page 16 for further details.

Business review

Analysis of results [continued](#)

Impairment losses

	2017	2016	2015
	£m	£m	£m
New impairment losses/(releases)	649	587	(552)
Less: recoveries of amounts previously written-off	(156)	(109)	(175)
Losses/(releases) to income statement	493	478	(727)
Comprising:			
Loan impairment losses/(releases)	530	537	(853)
Securities	(37)	(59)	126
Losses/(releases) to income statement	493	478	(727)

2017 compared with 2016

A net impairment loss of £493 million, 15 basis points of gross customer loans, compared with £478 million in 2016.

UK PBB reported a net impairment charge of £235 million, or 14 basis points of gross customer loans, reflecting continued benign credit conditions.

Ulster Bank RoI reported a net impairment loss of £60 million (68 million) compared with a £113 million (138 million) release in 2016. The charge for the year included a provision relating to a change in the non performing loan strategy to allow for further portfolio sales whilst 2016 included gains arising from the impact of asset disposals.

Commercial Banking net impairment losses of £362 million were £156 million higher than 2016, reflecting a small number of single name impairments.

NatWest Markets net impairment release of £174 million compared with a net impairment loss of £253 million in 2016 and mainly comprised releases relating to the legacy business.

REIL reduced by £1,406 million during 2017 to £8,904 million principally reflecting reductions in NatWest Markets, as legacy portfolios are run-down, and reductions across UK PBB and Ulster Bank RoI. REIL represented 2.7% of gross customer loans, compared with 3.1% in 2016.

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2016 compared with 2015

A net impairment loss of £478 million, 15 basis points of gross customer loans, compared with a net impairment release of £727 million in 2015.

UK PBB reported a net impairment loss of £125 million compared with £8 million in 2015.

Commercial Banking net impairment losses of £206 million were £137 million higher than 2015 and comprised a small number of single name impairments.

Ulster Bank RoI reported a net impairment release of £113 million (138 million) compared with £141 million (194 million) in 2015. The 2016 impairment release included a write back associated with the sale of a portfolio of loans. REIL remained stable at £3.5 billion in 2016 due to the strengthening of the euro, but in euro terms REIL reduced by 0.6 billion driven by the portfolio sale, partially offset by a widening of the definition of loans which are considered to be impaired.

REIL reduced by £1,847 million during 2016 to £10,310 million reflecting Capital Resolution run-down and a portfolio sale in Ulster Bank RoI partially offset by an increase in the shipping portfolio, foreign exchange movements and the implementation of a revised mortgage methodology in Ulster Bank RoI.

REIL represented 3.1% of gross customer loans compared with 3.9% at 31 December 2015. Provision coverage was 43% compared with 59% at 31 December 2015, with the reduction largely driven by Ulster Bank RoI and the legacy NatWest Markets business.

Tax

	2017	2016	2015
	£m	£m	£m
Tax charge	(824)	(1,166)	(23)
UK corporation tax rate	19.25%	20.00%	20.25%

2017 compared with 2016

The tax charge for the year ended 31 December 2017 is higher than the UK statutory tax rate reflecting the impact of the banking surcharge, non-deductible bank levy and conduct charges for which no tax relief has been recognised, a reduction in the carrying value and impact of UK tax rate changes on deferred tax balances. These factors have been offset partially by the release of tax provisions that reflect the reduction of exposures in countries where RBS is ceasing operations.

2016 compared with 2015

The tax charge for the year ended 31 December 2016 reflects the impact of the banking surcharge, non-deductible bank levy and conduct charges for which no tax relief has been recognised, a reduction in the carrying value and impact of UK tax rate changes on deferred tax balances, and the release of tax provisions that reflect the reduction of exposures in countries where RBS is ceasing operations.

Business review

Consolidated balance sheet as at 31 December 2017

	2017	2016
	£m	£m
Assets		
Cash and balances at central banks	98,337	74,250
Net loans and advances to banks	16,254	17,278
Reverse repurchase agreements and stock borrowing	13,997	12,860
Loans and advances to banks	30,251	30,138
Net loans and advances to customers	323,184	323,023
Reverse repurchase agreements and stock borrowing	26,735	28,927
Loans and advances to customers	349,919	351,950
Debt securities subject to repurchase agreements	23,781	18,107
Other debt securities	55,152	54,415
Debt securities	78,933	72,522
Equity shares	450	703
Settlement balances	2,517	5,526
Derivatives	160,843	246,981
Intangible assets	6,543	6,480
Property, plant and equipment	4,602	4,590
Deferred tax	1,740	1,803
Prepayments, accrued income and other assets	3,726	3,700
Assets of disposal groups	195	13
Total assets	738,056	798,656
Liabilities		
Bank deposits	39,479	33,317
Repurchase agreements and stock lending	7,419	5,239
Deposits by banks	46,898	38,556
Customer deposits	367,034	353,872
Repurchase agreements and stock lending	31,002	27,096
Customer accounts	398,036	380,968
Debt securities in issue	30,559	27,245
Settlement balances	2,844	3,645
Short positions	28,527	22,077
Derivatives	154,506	236,475
Provisions for liabilities and charges	7,757	12,836
Accruals and other liabilities	6,392	6,991
Retirement benefit liabilities	129	363
Deferred tax	583	662
Subordinated liabilities	12,722	19,419
Liabilities of disposal groups	10	15
Total liabilities	688,963	749,252
Non-controlling interests	763	795
Owners' equity	48,330	48,609
Total equity	49,093	49,404
Total liabilities and equity	738,056	798,656
Tangible net asset value per ordinary share (1)	294p	296p

Note:

- (1) Tangible net asset value per ordinary share represents tangible equity divided by the number of ordinary shares in issue.

Business review

Commentary on consolidated balance sheet

2017 compared with 2016

Total assets of £738.1 billion as at 31 December 2017 were down £60.6 billion, 7.6%, compared with 31 December 2016. This was primarily driven by decreases in derivative assets, partly offset by increased central bank deposits and loan growth in UK PBB and Commercial Banking.

Cash and balances at central banks increased by £24.1 billion, 32.5%, to £98.3 billion. This was primarily due to increased deposits received from the Bank of England Term Funding Scheme (TFS).

Loans and advances to banks increased by £0.2 billion, 0.7%, to £30.3 billion. Excluding reverse repurchase agreements and stock borrowing (reverse repos), which were up £1.1 billion, 8.5%, to £14.0 billion, bank placings declined £1.0 billion, 5.8%, to £16.3 billion.

Loans and advances to customers decreased by £2.0 billion, 0.6%, to £349.9 billion. Within this, reverse repos were down £2.2 billion, 7.6%, to £26.7 billion. Customer lending increased by £0.2 billion, 0.1%, to £323.2 billion. This reflected increases across the retail and commercial business, in particular in UK PBB mortgage lending offset by the run-down of the NatWest Markets legacy business.

Debt securities were up £6.4 billion, 8.8%, to £78.9 billion, mainly due to increased holdings in UK and European government securities in RBS Treasury.

Equity shares decreased by £0.2 billion, 28.6%, to £0.5 billion, primarily due to the sale of RBS's holding in EuroClear.

Settlement balances decreased by £3.0 billion, 54.5%, to £2.5 billion, primarily as a result of the run-down in the NatWest legacy business.

Movements in the value of derivative assets, down £86.2 billion, 34.9%, to £160.8 billion, and liabilities, down £82.0 billion, 34.7% to £154.5 billion, due to maturities, derivative mitigation activities, buyouts in NatWest Markets and mark-to-market movement as US dollar weakened against the Euro and Sterling.

Deposits by banks increased by £8.3 billion, 21.8%, to £46.9 billion, with increases in inter-bank deposits, up £6.2 billion, 18.6%, to £39.5 billion, primarily driven by amounts received under the TFS, offset by reductions in the cash collateral held against derivatives. Repurchase agreements and stock lending (repos), increased by £2.2 billion, 42.3%, to £7.4 billion, primarily driven by increased process efficiencies and increased trading

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activity partially offset by netting benefits in RBS Treasury and NatWest Markets.

Customer accounts increased £17.0 billion, 4.5%, to £398.0 billion. Within this, repos increased £3.9 billion to £31.0 billion. Excluding repos, customer deposits were up £13.1 billion, 3.7%, to £367.0 billion, primarily reflecting growth in UK PBB, Ulster Bank RoI and RBSI offset by run-down in the NatWest Markets legacy business.

Debt securities in issue increased by £3.4 billion, 12.5%, to £30.6 billion reflecting new covered bond issuances offset by maturities in RBS Treasury along with mark-to-market and foreign exchange movements.

Short positions increased by £6.4 billion, 29.0%, to £28.5 billion as a result of the increase in debt securities held.

Provisions for liabilities and charges decreased by £5.1 billion, 39.6%, to £7.8 billion, reflecting settlements being reached in various litigation cases, most notably in relation to US residential mortgage-backed securities claims.

Subordinated liabilities decreased by £6.7 billion, 34.5% to £12.7 billion, primarily as a result of the net decrease in dated and undated loan capital with redemptions of £4.2 billion and £1.5 billion respectively, reflecting on-going liability management activities.

Owners' equity decreased by £0.3 billion, 0.6%, to £48.3 billion, primarily driven by dividends paid and preference share redemptions offset by the £1.4 billion profit for the year.

Business review

Cash flow

	2017	2016	2015
	£m	£m	£m
Net cash flows from operating activities	38,741	(3,650)	918
Net cash flows from investing activities	(6,482)	(4,359)	(4,866)
Net cash flows from financing activities	(8,208)	(5,107)	(940)
Effects of exchange rate changes on cash and cash equivalents	(16)	8,094	576
Net increase/(decrease) in cash and cash equivalents	24,035	(5,022)	(4,312)

2017

The major factors contributing to the net cash inflow from operating activities of £38,741 million were an increase of £42,147 million in operating assets and liabilities, operating profit before tax of £2,239 million, other provisions charged net of releases of £1,930 million, depreciation and amortisation of £808 million and interest on subordinated liabilities of £572 million. These were partially offset by provisions utilised of £6,476 million, loans and advances written-off net of recoveries of £1,054 million and contributions to defined benefit pension schemes of £627 million.

Net cash outflows from investing activities of £6,482 million related to the net outflows from purchase and sale of securities of £5,556 million, the purchase of property, plant and equipment of £1,132 million and £199 million outflows from disposals, offset by net cash inflows from the sale of property, plant and equipment of £405 million.

Net cash outflows from financing activities of £8,208 million relate primarily to the redemption of subordinated liabilities of £5,747 million, redemption of debt preference shares of £748 million, redemption of paid-in equity of £720 million, interest paid on subordinated liabilities of £717 million and dividends paid of £612 million.

2016

The major factors contributing to the net cash outflow from operating activities of £3,650 million were the elimination of foreign exchange differences £6,518 million, contribution to defined benefit schemes of £4,786 million, loans and advances written-off net of recoveries of £3,586 million, operating loss before tax of £4,082 million and other provisions utilised of £2,699 million. These were partially offset by inflows from an increase of £8,413 million in operating assets and liabilities, other provisions charged net of releases of £7,216 million, interest on subordinated liabilities of £845 million and depreciation and amortisation of £778 million.

Net cash outflows from investing activities of £4,359 million related to the net outflows from purchase and sale of securities of £3,008 million, the purchase of property, plant and equipment of £912 million and £886 million outflows from disposals, offset by net cash inflows from the sale of property, plant and equipment of £447 million.

Net cash outflows from financing activities of £5,107 million relate primarily to the redemption of subordinated liabilities of £3,606 million, redemption of equity preference shares of £1,160 million, the final payment to retire the Dividend Access Share of £1,193 million and interest paid on subordinated liabilities of £813 million. These outflows were partly offset by the inflow from the issuance of Additional Tier 1 capital notes of £2,046 million.

2015

The major factors contributing to the net cash inflow from operating activities of £918 million were the increase of £8,589 million in operating assets and liabilities, other provisions charged net of releases of £4,566 million, write down of goodwill and other intangible assets £1,332 million and depreciation and amortisation of £1,180 million. These were partially offset by loans and advances written-off net of recoveries of £8,789 million, other provisions utilised of £2,202 million, elimination of foreign exchange differences of £1,501 million, profit on sale of subsidiaries and associates of £1,135 million, cash contribution to defined benefit pension schemes of £1,060 million, decrease in income accruals of £1,075 million and the operating loss before tax of £937 million.

Net cash outflows from investing activities of £4,866 million related to the net outflows from purchase of securities of £5,906 million and the purchase of property, plant and equipment of £783 million, offset by inflows of £391 million from disposals, primarily Citizens and net cash inflows from the sale of property, plant and equipment of £1,432 million.

Net cash outflows from financing activities of £940 million relate primarily to the redemption of subordinated liabilities of £3,047 million, redemption of preference shares of £1,214 million and interest paid on subordinated liabilities of £975 million partly offset by the proceeds of non-controlling interests issued of £2,537 million and the issue of Additional Tier 1 capital notes of £2,012 million

Business review

Financial summary

RBS's financial statements are prepared in accordance with IFRS. Selected data under IFRS for each of the last five years is presented below.

	2017	2016	2015	2014	2013
	£m	£m	£m	£m	£m
Summary consolidated income statement					
Net interest income	8,987	8,708	8,767	9,258	9,017
Non-interest income (1,2,3)	4,146	3,882	4,156	5,892	7,720
Total income	13,133	12,590	12,923	15,150	16,737
Operating expenses (4)	(10,401)	(16,194)	(16,353)	(13,859)	(17,466)
Profit/(loss) before impairment (losses)/releases	2,732	(3,604)	(3,430)	1,291	(729)
Impairment (losses)/releases	(493)	(478)	727	1,352	(8,120)
Operating profit/(loss) before tax	2,239	(4,082)	(2,703)	2,643	(8,849)
Tax charge	(824)	(1,166)	(23)	(1,909)	(186)
Profit/(loss) from continuing operations	1,415	(5,248)	(2,726)	734	(9,035)
Profit/(loss) from discontinued operations, net of tax (5)			1,541	(3,445)	558
Profit/(loss) for the year	1,415	(5,248)	(1,185)	(2,711)	(8,477)
Attributable to:					
Non-controlling interests	35	10	409	60	120
Preference shareholders	234	260	297	330	349
Paid-in equity holders	394	244	88	49	49
Dividend access share		1,193		320	
Ordinary shareholders	752	(6,955)	(1,979)	(3,470)	(8,995)
	1,415	(5,248)	(1,185)	(2,711)	(8,477)

Notes:

(1) Includes profit on strategic disposals of £347 million (2016 - £164 million profit; 2015 - £157 million loss; 2014 - £191 million profit; 2013 - £161 million profit).

(2) Includes loss on redemption of own debt of £7 million (2016 - £126 million loss; 2015 - £263 million loss; 2014 - £20 million gain; 2013 - £175 million gain).

(3) Includes own credit adjustments of £69 million loss (2016 - £180 million gain; 2015 - £309 million gain; 2014 - £146 million loss; 2013 - £120 million loss).

(4) Includes no write down of goodwill in 2017 (2016 - nil; 2015 - £498 million; 2014 - £130 million; 2013 - £1,059 million).

(5) Includes a gain of £1,117 million relating to the sell-down of Citizens in 2015 (2014 - £3,994 million loss).

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	2017	2016	2015	2014	2013
	£m	£m	£m	£m	£m
Summary consolidated balance sheet					
Loans and advances	380,170	382,088	364,538	421,973	494,793
Debt securities and equity shares	79,383	73,225	83,458	92,284	122,410
Derivatives and settlement balances	163,360	252,507	266,630	358,257	293,630
Other assets	115,143	90,836	100,782	178,505	116,989
Total assets	738,056	798,656	815,408	1,051,019	1,027,822
Owners' equity	48,330	48,609	53,431	55,763	58,658
Non-controlling interests	763	795	716	2,946	473
Subordinated liabilities	12,722	19,419	19,847	22,905	24,012
Deposits	444,934	419,524	408,594	452,304	534,859
Derivatives, settlement balances and short positions	185,877	262,197	278,904	377,337	318,861
Other liabilities	45,430	48,112	53,916	139,764	90,959
Total liabilities and equity	738,056	798,656	815,408	1,051,019	1,027,822

Business review

Other financial data

Share information	2017	2016	2015	2014	2013
Basic and diluted earnings/(loss) per ordinary share from continuing operations - pence (1)	6.3	(59.5)	(27.7)	0.5	(85.0)
Share price per ordinary share at year end - £	2.78	2.25	3.02	3.94	3.38
Market capitalisation at year end - £bn	33.3	26.6	35.1	45.2	38.2
Net asset value per ordinary share - £	4.10	4.18	4.66	5.12	5.23
Capital ratios					
Return on average total assets (2)	0.1%	(0.8%)	(0.2%)	(0.3%)	(0.7%)
Return on average total equity (3)	2.0%	(10.2%)	(2.9%)	(4.6%)	(12.8%)
Return on average ordinary shareholders' equity (4)	1.9%	(15.3%)	(4.0%)	(6.5%)	(14.7%)
Average total equity as a percentage of average total assets	7.0%	6.2%	6.0%	5.8%	5.5%
Risk asset ratio - Tier 1 (5)	19.7%	17.7%	19.1%	13.2%	13.1%
Risk asset ratio - Total (5)	23.9%	22.9%	24.7%	17.1%	16.5%
Earnings ratio					
Ratio of earnings to combined fixed charges and preference share dividends (6,7)					
- including interest on deposits	1.58	(0.45)	0.17	1.52	(0.51)
- excluding interest on deposits	2.25	(2.13)	(1.17)	2.61	(5.12)
Ratio of earnings to fixed charges only (6,7)					
- including interest on deposits	2.05	(0.53)	0.19	1.67	(0.55)
- excluding interest on deposits	4.37	(3.25)	(1.60)	3.58	(6.95)

Notes:

- (1) None of the convertible securities had a dilutive effect in the years 2013 to 2017.
- (2) Return on average total assets represents loss attributable to ordinary shareholders as a percentage of average total assets.
- (3) Return on average total equity represents loss attributable to equity owners expressed as a percentage of average shareholder funds.
- (4) Return on average ordinary shareholders' equity represents loss attributable to ordinary shareholders expressed as a percentage of average ordinary shareholders' equity.
- (5) 2017, 2016, 2015 and 2014 are calculated on a PRA transitional basis; 2013 is calculated on a Basel 2.5 basis.

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(6) For this purpose, earnings consist of income before tax and non-controlling interests, plus fixed charges less the unremitted income of associated undertakings (share of profits less dividends received). Fixed charges consist of total interest expense, including or excluding interest on deposits and debt securities in issue, as appropriate, and the proportion of rental expense deemed representative of the interest factor (one third of total rental expenses).

(7) The earnings for the years ended 31 December 2016, 2015 and 2013 were inadequate to cover total fixed charges and preference share dividends. The coverage deficiency for total fixed charges and preference share dividends for the years ended 31 December 2016, 2015 and 2013 was £4,586 million, £3,088 million and £9,247 million respectively. The coverage deficiency for fixed charges for they years ended 31 December 2016, 2015 and 2013 was £4,082 million, £2,703 million and £8,849 million respectively.

Business review

Segment performance

UK Personal & Business Banking

	2017	2016	2015
	£m	£m	£m
Income statement			
Net interest income	5,130	4,945	4,810
Net fees and commissions	1,099	1,147	1,180
Other non-interest income	248	35	43
Non-interest income	1,347	1,182	1,223
Total income	6,477	6,127	6,033
Direct expenses			
- staff costs	(773)	(832)	(950)
- other costs	(259)	(320)	(297)
Indirect expenses	(2,126)	(2,246)	(2,150)
Restructuring costs			
- direct	(79)	(46)	(66)
- indirect	(382)	(198)	(129)
Litigation and conduct costs	(210)	(634)	(972)
Operating expenses	(3,829)	(4,276)	(4,564)
Operating profit before impairment losses	2,648	1,851	1,469
Impairment losses	(235)	(125)	(8)
Operating profit	2,413	1,726	1,461
Operating expenses - adjusted (1)	(3,158)	(3,398)	(3,397)
Operating profit - adjusted (1)	3,084	2,604	2,628
Analysis of income by product			
Personal advances	998	1,010	839
Personal deposits	841	732	817
Mortgages	2,641	2,560	2,534
Cards	743	653	666
Business banking	781	737	726
Commercial	417	415	394
Other	56	20	57
Total income	6,477	6,127	6,033
Analysis of impairments by sector			
Personal advances	167	105	84
Mortgages	(42)	(20)	1
Cards	82	36	14
Business banking	4	(11)	(79)
Commercial	24	15	(1)
Other			(11)
Total impairment losses	235	125	8
Loan impairment charge/(release) as a % of gross customer loans and advances (excluding reverse repurchase agreements) by sector			

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Personal advances	2.4%	1.5%	1.2%
Cards	2.1%	0.9%	0.3%
Business banking	0.1%	(0.2%)	(1.5%)
Commercial	0.3%	0.2%	
Other			(0.8%)
Total	0.1%	0.1%	
Performance ratios			
Return on equity (2)	23.7%	16.2%	13.5%
Return on equity - adjusted (1,2)	30.7%	25.1%	25.3%
Net interest margin	2.86%	2.97%	3.13%
Cost:income ratio	59.1%	69.8%	75.7%
Cost:income ratio - adjusted (1)	48.8%	55.5%	56.3%

Notes:

(1) Excluding restructuring costs and litigation and conduct costs.

(2) Return on equity is based on segmental operating profit after tax adjusted for preference dividends divided by average notional equity based on 15% of the monthly average of segmental RWAs, assuming 28% tax rate.

Business review

UK Personal & Business Banking *continued*

	2017 £bn	2016 £bn	2015 £bn
Capital and balance sheet			
Loans and advances to customers (gross)			
- personal advances	7.1	6.9	6.9
- mortgages	136.8	128.0	115.3
- cards	4.0	4.2	4.4
- business banking	6.8	6.3	5.3
- commercial	8.3	8.8	8.7
- other			1.3
Total loans and advance to customers (gross)	163.0	154.2	141.9
Loan impairment provisions	(1.3)	(1.5)	(2.1)
Net loans and advances to customers	161.7	152.7	139.8
Total assets	190.6	181.4	168.0
Funded assets	190.6	181.4	168.0
Risk elements in lending	2.0	2.4	3.2
Provision coverage (1)	65%	65%	68%
Customer deposits			
- personal current accounts	49.6	45.3	40.9
- personal savings	92.8	88.5	86.6
- business banking	23.9	21.5	19.6
- commercial	14.3	14.7	12.7
- other			2.1
Total customer deposits	180.6	170.0	161.9
Assets under management (excluding deposits)	4.1	4.2	4.3
Loan:deposit ratio (excluding repos)	90%	90%	86%
Risk-weighted assets			
- Credit risk (non-counterparty)	33.7	33.0	33.9
- Operational risk	9.3	9.3	9.3
Total risk-weighted assets	43.0	42.3	43.2

Note:

(1) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

Business review

UK Personal & Business Banking *continued*

Serving our customers

UK PBB continues to invest in our digital channel offering and now has 5.5 million customers regularly using our mobile app, 20% higher than December 2016, representing 68% digital penetration of our active current account customers.

Digital sales volumes increased by 11% in 2017, while the number of digital service transactions rose by 7% in the year as the number of branch transactions fell by 9%, demonstrating the changing behaviour of our customers. Further enhancements were made during 2017, along with the introduction of a TechXpert in every branch to support customers in the use of digital banking tools. NatWest was awarded Best Banking App at the British Bank Awards in 2017 and we continue to receive very positive customer feedback.

Given the change in customer behaviour and expectations over the past few years, we recently announced further branch closures. We recognise that branch interactions are still important for some customers and we have a significant branch network, which we continue to upgrade and improve, as well as our investment in mobile branches and Community Bankers in addition to access to Post Office services to meet these customer requirements.

UK PBB continued to deliver strong support to personal customers with mortgage balance growth of 7.0% compared with 2016. We continued to drive improvements in our customer mortgage experience, including being the first bank to launch a paperless mortgage journey, with NatWest Intermediary Solutions named Best Overall Lender at the 2017 Mortgage Advice Bureau Awards. Personal unsecured loans also saw balance growth of 7% compared with 2016 supported by an improved customer experience, with increased mobile functionality and simplified application processing resulting in digital loan sales growth of 20% compared with 2016 and 50% of sales transacted via this channel. Our overall personal unsecured risk appetite remains consistent with 2016, with new business quality stable on 2016.

The Reward proposition continued to grow with more than 1,450,000 customer accounts, 26% higher than December 2016. We repositioned the Reward account proposition from 26 June 2017, including the introduction of minimum customer criteria, supporting improved returns in the second half of 2017.

Our free Financial Health Check continues to provide personal and business customers with advice on their financial position and what options are open to them, including adoption of digital banking. More than 1,300,000 Financial Health Checks have been completed in 2017.

Our business banking segment continues to deliver customer improvements with an enhanced digital offering, with 80% of accounts opened during the last quarter of 2017 using this channel, and a simplified new lending process for loans up to £50,000, delivering same day loan approval and supporting ongoing productivity improvements. Following a successful pilot the FreeAgent accounting software rollout was extended in Q4 2017, with more than 8,300 customers now registered users.

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Our business banking risk appetite remains consistent with 2016 with new business quality broadly stable on 2016.

2017 compared with 2016

Operating profit was £2,413 million compared with £1,726 million in 2016. The increase was driven by higher income, lower adjusted operating expenses(1) and lower litigation and conduct charges, partially offset by higher restructuring costs, largely relating to the reduction in our property portfolio and costs associated with the business previously described as Williams & Glyn, and higher impairments. Return on equity increased to 23.7% from 16.2% in 2016.

Total income of £6,477 million was £350 million, or 5.7%, higher than 2016, principally reflecting strong balance growth, savings re-pricing benefits and a £185 million debt sale gain. Net interest margin declined by 11 basis points to 2.86% driven by lower mortgage margins, asset mix and reduced current account hedge yield, partially offset by savings re-pricing benefits from actions taken in 2016 and following the Q4 2017 base rate increase.

Operating expenses decreased £447 million, or 10.5%, to £3,829 million. Adjusted operating expenses(1) decreased by £240 million, or 7.1%, to £3,158 million compared with 2016 driven by a £59 million, or 7.1%, reduction in staff costs, with headcount down 8.3%, and a £181 million reduction in operational costs following process and productivity improvements in service operations and re-integration benefits in respect of the business previously described as Williams & Glyn(2). Cost:income ratio improved to 59.1% in 2017 compared with 69.8% in 2016. Adjusted cost:income ratio(1) improved to 48.8% in 2017 compared with 55.5% in 2016.

The net impairment charge of £235 million, or 14 basis points of gross customer loans, reflected continued benign credit conditions. 2017 had lower recoveries partly as a result of the debt sales undertaken, compared with 2016. Defaults remained at very low levels across all portfolios compared to historic trends, although slightly higher than in 2016.

Net loans and advances increased by £9.0 billion, or 5.9%, to £161.7 billion as UK PBB continued to deliver support for both personal and business banking customers. Gross new mortgage lending in 2017 was £31.0 billion with market share of new mortgages at approximately 12%, resulting in stock share of approximately 10% at 31 December 2017 compared with 9.7% at 31 December 2016. Positive momentum continued across business banking lending, with net balances up 3.0% compared with 31 December 2016, adjusting for transfers(4).

Customer deposits increased by £10.6 billion, or 6.2%, to £180.6 billion, driven by strong personal current account and business deposit growth.

UK PBB includes commercial income from the business previously described as Williams & Glyn of approximately £417 million, gross loans and advances of £8.3 billion and deposits of £14.3 billion. An estimated £70 million of the commercial income, £1.7 billion of gross loans and advances and £1.8 billion of deposits relates to mid-corporate customers not subject to the European Commission alternative remedies package. 120,000 of the remaining approximately 220,000 customers will be subject to the remedies package.

Business review

UK Personal & Business Banking *continued*

2016 compared with 2015

Operating profit was £1,726 million, compared with £1,461 million in 2015, and included a £634 million litigation and conduct charge, principally in respect of additional PPI provisions. Adjusted operating profit(1) of £2,604 million was £24 million, or 1%, lower than 2015 principally reflecting higher impairment losses, partially offset by net interest income.

Total income of £6,127 million increased by £94 million, or 2%, compared with 2015, despite the lower rate environment depressing earnings on current accounts and the impact of regulatory changes impacting interchange fees. Net interest income was robust, increasing by £135 million, or 3%, reflecting continued strong asset growth combined with the active repricing of our deposit book. This more than offset the impact of lower current account hedge returns and lower mortgage margins. Net interest margin declined by 16 basis points to 2.97% reflecting the change in the overall portfolio mix and reduced mortgage margins. During the second half of 2016 mortgage SVR balances stabilised at approximately 12%, broadly in line with historical levels.

Non-interest income reduced by £41 million, or 3%, principally reflecting lower credit card interchange fees, following regulatory changes introduced in 2015. In addition, cash back payments on the Reward account have impacted fee income, however, we have seen increased levels of customer engagement. Partially offsetting, we recognised a £19 million debt sale gain in 2016.

Operating expenses decreased £288 million, or 6.3%, to £4,276 million. Adjusted operating expenses(1) remained the same. Direct staff costs were £118 million, or 12%, lower driven by an 17% reduction in headcount reflecting the continued movement to digital channels, exiting of business lines with returns below required levels and some centralisation of administrative activities. This was partially offset by additional investment costs of £102 million, including one-off intangible asset write-downs of £56 million in 2016, together with a £21 million increase in regulatory charges and increase in costs related to the business previously described as Williams & Glyn.

The net impairment charge of £125 million reflects continued benign credit conditions and compared with a £8 million charge in 2015, with the increase principally reflecting reduced portfolio provision releases. The default driven charge was 13% lower, excluding the business previously described as Williams & Glyn(2), than 2015 with REIL 25% lower and provision coverage remaining strong at 65%.

Net loans and advances of £152.7 billion increased by £12.9 billion, or 9%, compared with 2015 principally driven by mortgage growth of 11%. We continue to see positive momentum across business and personal unsecured lending, up by 6%, excluding transfers(4), and 9% respectively.

We continue to build on our strong mortgage market position with gross balances increasing by 11% to £128.0 billion compared with 3% growth for the overall mortgage market. Gross new lending in 2016 was £31.9 billion, representing a market share of approximately 13% compared with a

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stock share of approximately 9.7% at 31 December 2016, up from 8.9% in 2015.

New business margins were stable over 2016 whilst margins on existing customers remortgaging have improved. Gross new business banking lending to small and medium-sized enterprises of £1.6 billion was up 43% compared with 2015. Personal loan gross new lending of £2.7 billion was up 25% supported by the launch of functionality for a customer to apply via the mobile app combined with improvements to customer experience. We have continued to take a cautionary risk approach to personal unsecured lending. As a result, personal unsecured cards and overdrafts balances have decreased by £0.3 billion, or 5%, compared with 2015, and margins have widened.

Deposit balances performed strongly, increasing by £8.1 billion, or 5%, to £170.0 billion driven by 11% growth in personal current account balances. Personal savings balances increased 2% despite repricing activity.

RWAs decreased by £0.9 billion, or 3%, to £33.0 billion due to asset mix benefits and overall improved credit quality, largely reflecting the current benign credit conditions, partly offset by increased lending.

Notes:

(1) Refer to income statement reconciliations on page 120.

(2) The business previously described as Williams & Glyn was integrated in to the reportable operating segment UK PBB in Q4 2017 and prior year comparatives re-presented.

(3) UK PBB Collective Investment Funds (CIFL) business was transferred to Private Banking on 1 October 2017. CIFL Business transfer included total income of £33 million and total expenses of £9 million. Comparatives were not re-presented.

(4) Transfers include £0.4 billion loans and advances transferred from Commercial Banking to UK PBB during 2017 to better align Business banking customers. Comparatives were not re-presented.

Business review

Ulster Bank Rol

	2017	2016	2015	2017	2016	2015
	m	m	m	£m	£m	£m
Income statement						
Net interest income	480	501	503	421	409	365
Net fees and commissions	107	100	116	94	82	85
Other non-interest income	106	100	139	92	82	100
Own credit adjustments	(4)	3		(3)	3	
Non-interest income	209	203	255	183	167	185
Total income	689	704	758	604	576	550
Direct expenses						
- staff costs	(218)	(252)	(220)	(191)	(207)	(160)
- other costs	(76)	(68)	(116)	(66)	(55)	(85)
Indirect expenses	(222)	(239)	(251)	(194)	(195)	(182)
Restructuring costs						
- direct	(31)	(46)	(17)	(27)	(38)	(12)
- indirect	(33)	(2)	(4)	(29)	(2)	(3)
Litigation and conduct costs	(192)	(211)	18	(169)	(172)	13
Operating expenses	(772)	(818)	(590)	(676)	(669)	(429)
Operating (loss)/profit before impairment (losses)/releases	(83)	(114)	168	(72)	(93)	121
Impairment (losses)/releases	(68)	138	194	(60)	113	141
Operating profit/(loss)	(151)	24	362	(132)	20	262
Total income - adjusted (1)	693	701	758	607	573	550
Operating expenses - adjusted (2)	(516)	(559)	(587)	(451)	(457)	(427)
Operating profit - adjusted (1,2)	109	280	365	96	229	264
Average exchange rate - /£				1.142	1.224	1.377
Analysis of income by business						
Corporate	214	215	202	187	176	147
Retail	473	479	443	415	392	321
Other	2	10	113	2	8	82
Total income	689	704	758	604	576	550
Analysis of impairments by sector						
Mortgages	83	35	(100)	72	29	(73)
Commercial real estate						
- investment	(7)	(30)	7	(6)	(24)	5
- development	(4)	(25)		(3)	(20)	(1)
Other lending	(4)	(118)	(101)	(3)	(98)	(72)
Total impairment (losses)/releases	68	(138)	(194)	60	(113)	(141)

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Loan impairment charge/(release) as a % of gross customer loans and advances (excluding reverse repurchase agreements) by sector

Mortgages	0.5%	0.2%	(0.5%)	0.5%	0.2%	(0.5%)
Commercial real estate						
- investment	(0.7%)	(3.8%)	0.8%	(0.7%)	(3.4%)	0.7%
- development	(4.0%)	(8.3%)		(3.0%)	(10.0%)	(0.5%)
Other lending	(0.1%)	(2.6%)	(1.9%)	(0.1%)	(2.5%)	(1.8%)
Total	0.3%	(0.6%)	(0.8%)	0.3%	(0.6%)	(0.8%)

Performance ratios

Return on equity (3)	(5.0%)	0.7%	10.6%	(5.0%)	0.7%	10.6%
Return on equity - adjusted (1,2,3)	3.6%	8.4%	10.6%	3.6%	8.4%	10.6%
Net interest margin	1.67%	1.62%	1.57%	1.67%	1.62%	1.57%
Cost:income ratio	111.9%	116.1%	78.0%	111.9%	116.1%	78.0%
Cost:income ratio - adjusted (1,2)	74.3%	79.8%	77.6%	74.3%	79.8%	77.6%

Notes:

(1) Excluding own credit adjustments.

(2) Excluding restructuring costs and litigation and conduct costs.

(3) Return on equity is based on segmental operating profit after tax adjusted for preference share dividends divided by average notional equity (based on 14% (11% prior to Q1 2017) of the monthly average of segmental risk-weighted assets incorporating the effect of capital deductions (RWAes)), assuming 15% tax rate up to and including FY 2016, nil tax thereafter.

Business review

Ulster Bank Rol continued

	2017 bn	2016 bn	2015 bn	2017 £bn	2016 £bn	2015 £bn
Capital and balance sheet						
Loans and advances to customers (gross)						
Mortgages	17.3	17.9	18.8	15.4	15.3	13.8
Commercial real estate						
- investment	1.0	0.8	0.9	0.9	0.7	0.7
- development	0.1	0.3	0.3	0.1	0.2	0.2
Other lending	4.9	4.5	5.3	4.2	3.9	3.9
Total loans and advances to customers (gross)	23.3	23.5	25.3	20.6	20.1	18.6
Loan impairment provisions						
Mortgages	(1.0)	(1.1)	(1.4)	(0.9)	(0.9)	(1.1)
Commercial real estate						
- investment			(0.2)			(0.1)
- development			(0.1)			(0.1)
Other lending	(0.3)	(0.3)	(0.9)	(0.2)	(0.3)	(0.6)
Total loan impairment provisions	(1.3)	(1.4)	(2.6)	(1.1)	(1.2)	(1.9)
Net loans and advances to customers	22.0	22.1	22.7	19.5	18.9	16.7
Total assets	27.7	28.2	29.0	24.6	24.1	21.3
Funded assets	27.6	28.0	28.8	24.5	24.0	21.2
Risk elements in lending						
- mortgages	3.4	3.7	3.5	3.0	3.1	2.6
- commercial real estate						
- investment			0.2			0.2
- development			0.1			0.1
- other lending	0.3	0.4	0.9	0.3	0.4	0.6
Total risk elements in lending	3.7	4.1	4.7	3.3	3.5	3.5
Provision coverage (1)	34%	34%	55%	34%	34%	55%
Customer deposits	19.8	18.8	17.8	17.5	16.1	13.1
Loan:deposit ratio (excluding repos)	111%	117%	127%	111%	117%	127%
Risk-weighted assets						
- Credit risk						
- non-counterparty	18.9	19.7	24.6	16.9	16.9	18.1
- counterparty	0.1	0.1	0.1	0.1	0.1	0.1
- Market risk	0.1			0.1		
- Operational risk	1.1	1.3	1.7	0.9	1.1	1.2
Total risk-weighted assets	20.2	21.1	26.4	18.0	18.1	19.4
Spot exchange rate - /£				1.127	1.168	1.362

Note:

- (1) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

Business review

Ulster Bank RoI [continued](#)

Serving our customers

Gross new lending increased 7.2% (3.4% in euro terms) on prior year, primarily reflecting higher commercial lending. The bank's mortgage lending exceeded £0.9 billion (1 billion) in 2017 supported by successful home mover advertising campaigns and an improved customer proposition.

Ulster Bank RoI has continued its journey to become number one in the market for customer trust and advocacy. Investment in the digital platform has focused on providing enhancements that make it easier for customers to bank with us. Ulster Bank RoI was amongst the first banks in Ireland to introduce Apple Pay and Android Pay and now over 70% of our customers are actively using our digital proposition, increased from 58% of our active customer base in 2016.

In August, Ulster Bank RoI was the first in Ireland to launch Open Banking. Using market-leading technology, Ulster Bank RoI gives approved third parties limited access to a customer's account balance and transaction history, if the customer approves access.

The bank has proactively helped to protect customers from fraud and scams. Community Protection Advisers have run over 70 sessions across the country helping people understand how they can keep themselves safe online and outlining how to identify scams.

2017 compared with 2016

An operating loss of £132 million (151 million) compared with a £20 million (24 million) profit in 2016 primarily reflecting a £173 million (206 million) increase in impairment losses, largely relating to a change in the non performing loan strategy to allow for further portfolio sales.

Total income of £604 million (689 million) was £28 million, or 4.9% higher than in 2016 (15 million, or 2.1% lower in euro terms). Adjusted income(1) of £607 million (693 million) was £34 million, or 5.9% higher than 2016 (8 million, or 1.1%, lower than 2016 in euro terms), primarily reflecting a £46 million (53 million) reduction in income on free funds, partially offset by one off items, higher lending income and reduced funding costs. Net interest margin of 1.67% was 5 basis points higher than 2016 reflecting a combination of improved deposit and loan margins, one-off income adjustments and successful deleveraging measures in 2016 which have reduced the concentration of low yielding loans.

Operating expenses were £676 million, an increase of £7 million, or 1.0% compared with 2016 (a decrease of 46 million, or 5.6% to 772 million in euro terms). Adjusted operating expenses(1) decreased £6 million or 1.3% to £451 million; in euro terms adjusted operating expenses(1) of 516

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million were 43 million, or 7.7%, lower than 2016. This was primarily due to continued progress in the delivery of cost saving initiatives, as evidenced by a 12.9% reduction in headcount, and lower pension costs. Cost:income ratio was 111.9% compared with 116.1% in 2016. Adjusted cost:income ratio(1) of 74.3% compared with 79.8% in 2016.

A litigation and conduct provision of £169 million (192 million) related to customer remediation and project costs associated with legacy business issues.

A net impairment loss of £60 million (68 million) compared with a £113 million (138 million) release in 2016. The movement was driven by a provision relating to a change in the non performing loan strategy to allow for further portfolio sales, gains associated with asset disposals in 2016 and refinements to the mortgage provision models in 2017. REILs were £3.3 billion, 5.7% lower than 2016 (3.7 billion, 9.8% in euro terms) reflecting credit quality improvements.

Ulster Bank RoI gross new lending was £2.3 billion in 2017, up 7.2% compared with 2016 (2.6 billion, up 3.4% in euro terms).

RWAs remained stable at £18.0 billion, compared with £18.1 billion in 2016. In euro terms, RWAs of 20.2 billion reduced by 0.9 billion, or 4.3%, compared with 2016.

2016 compared with 2015

Operating profit decreased by £242 million (338 million) to £20 million (24 million) compared with 2015 primarily due to an increase in litigation and conduct costs of £185 million (229 million) and a £28 million (56 million) reduction in net impairment releases. Adjusted operating profit(1) of £229 million (280 million), was £35 million, or 13%, (85 million, or 23% in euro terms) lower than prior year. Excluding the impact of the strengthening euro, the decrease in adjusted operating profit was driven by a reduction in adjusted operating expenses which was more than offset by the non recurrence of certain income benefits in 2015 and lower impairment releases.

Net interest income increased by £44 million to £409 million compared with 2015 due to the strengthening of the euro but net interest income was stable year on year, in euro terms. Net interest margin increased by 5 basis points to 1.62%, compared with 2015, driven by a continued reduction in the cost of deposits and a reduced volume of low yielding liquid assets, partly offset by reduced income on free funds.

Non interest income decreased by £18 million, or 10%, (52 million, or 20% in euro terms), principally reflecting a £24 million (33 million gain) realised on the closure of a foreign exchange exposure in 2015 and an £11 million (13 million) interim adjustment to the pricing of FX transactions between Ulster Bank RoI and NatWest Markets in 2016, pending completion of a detailed pricing review.

Business review

Ulster Bank Rol [continued](#)

Operating expenses increased £240 million, or 56%, to £669 million (£228 million, or 39%, to 818 million). Adjusted operating expenses(1) increased £30 million, or 7%, to £457 million due to the strengthening of the euro. In euro terms, adjusted operating expenses(1) reduced by £28 million, or 5%, to £559 million reflecting a combination of progress made on cost saving initiatives, the non recurrence of one off costs in 2015 and one off accrual releases in 2016.

A realignment of costs within direct expenses contributed to an increase in staff costs in 2016 with an offsetting reduction in other costs. This reflects the reallocation of 660 staff from UK PBB to align with current management responsibilities following the separation of the Northern Ireland and Republic of Ireland businesses. Excluding the reallocation from UK PBB and staff supporting the tracker mortgage examination and asset disposal programmes, headcount decreased by 9% year on year.

Litigation and conduct costs of £172 million (£211 million) principally reflect a provision for remediation and programme costs associated with an industry wide examination of tracker mortgages. Restructuring costs increased by £25 million (£27 million) to £40 million (£48 million), primarily driven by costs associated with asset disposal activity.

A net impairment release of £113 million (£138 million) comprised write-backs associated with asset disposals and benefited from improved macroeconomic conditions.

Risk elements in lending remained stable at £3.5 billion in 2016 due to the strengthening of the euro, but in euro terms the sale of a portfolio of loans contributed to a £0.6 billion, or 13%, reduction in risk elements in lending in 2016 to 4.1 billion. This was partially offset by a widening of the definition of loans which are considered to be impaired to include multiple forbearance arrangements and probationary mortgages. The provision coverage ratio reduced from 55% in 2015 to 34% in 2016 largely reflecting a further de-risking of the balance sheet following recent asset sales of largely non-performing loans.

Gross new lending increased 31% in 2016, net loans and advances increased £2.2 billion due to the strengthening of the euro but decreased £0.6 billion, or 3%, in euro terms as new lending was offset by asset disposals and repayments. The low yielding tracker mortgage portfolio increased by £0.6 billion or 7% including the impact of the euro exchange rate movement (declined by £1.0 billion, or 9%, in euro terms) to £9.2 billion (£10.8 billion) at 31 December 2016 supported by repayments and asset disposals.

RWAs reduced by £1.3 billion or 7% (£5.3 billion or 20% in euro terms) during 2016 to £18.1 billion (£21.1 billion) driven by the sale of a portfolio of loans combined with adjustments to the mortgage modelling approach and an improvement in the macro economic environment. RWAs on the tracker mortgage portfolio reduced by £1.5 billion, or 19% (£3.3 billion or 31% in euro terms), during 2016 to £6.3 billion (£7.4 billion).

Loan:deposit ratio decreased 10 percentage points to 117% in 2016 supported by a £3 billion (1.0 billion) growth in deposits and reduced net loans following recent asset sales.

Note:

(1) Refer to income statement reconciliations on page 120.

Business review

Commercial Banking

	2017	2016	2015
	£m	£m	£m
Income statement			
Net interest income	2,286	2,143	1,997
Net fees and commissions	1,030	1,031	984
Other non-interest income	168	241	273
Non-interest income	1,198	1,272	1,257
Total income	3,484	3,415	3,254
Direct expenses			
- staff costs	(467)	(522)	(483)
- operating lease costs	(142)	(141)	(141)
- other costs	(90)	(94)	(97)
Indirect expenses	(1,115)	(1,179)	(1,080)
Restructuring costs			
- direct	(48)	(25)	(52)
- indirect	(119)	(83)	(17)
Litigation and conduct costs	(33)	(423)	(51)
Operating expenses	(2,014)	(2,467)	(1,921)
Operating profit before impairment losses	1,470	948	1,333
Impairment losses	(362)	(206)	(69)
Operating profit	1,108	742	1,264
Operating expenses - adjusted (1)	(1,814)	(1,936)	(1,801)
Operating profit - adjusted (1)	1,308	1,273	1,384
Analysis of income by business			
Commercial lending	1,880	1,875	1,634
Deposits	508	474	477
Asset and invoice finance	662	712	710
Other	434	354	433
Total income	3,484	3,415	3,254
Analysis of impairments by sector			
Commercial real estate	29	4	18
Asset and invoice finance	57	35	9
Private sector services (education, health, etc)	22	8	9
Banks & financial institutions		2	
Wholesale and retail trade repairs	59	15	3
Hotels and restaurants	1	27	(2)
Manufacturing	5	3	1
Construction	187	18	6
Other	2	94	25
Total impairment losses	362	206	69
Loan impairment charge as a % of gross customer loans and advances by sector			
Commercial real estate	0.2%		0.1%
Asset and invoice finance	0.4%	0.2%	0.1%
Private sector services (education, health, etc)	0.3%	0.1%	0.1%
Wholesale and retail trade repairs	0.8%	0.2%	
Hotels and restaurants		0.7%	(0.1%)
Manufacturing	0.1%		
Construction	9.4%	0.8%	0.3%

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Other			0.3%	0.1%
Total	0.4%	0.2%	0.1%	

Note:

(1) Excluding restructuring costs and litigation and conduct costs.

Business review

Commercial Banking *continued*

	2017	2016	2015
Performance ratios	%	%	%
Return on equity (1)	6.6%	4.1%	9.8%
Return on equity - adjusted (1,2)	8.2%	8.4%	10.9%
Net interest margin	1.74%	1.76%	1.88%
Cost:income ratio	56.0%	71.0%	57.2%
Cost:income ratio - adjusted (2)	50.0%	54.8%	53.3%
Capital and balance sheet	£bn	£bn	£bn
Loans and advances to customers (gross)			
- Commercial real estate	15.4	16.9	16.7
- Asset and invoice finance	16.1	14.1	14.4
- Private sector services (education, health, etc)	6.9	6.9	6.7
- Banks & financial institutions	7.1	8.9	7.1
- Wholesale and retail trade repairs	7.8	8.4	7.5
- Hotels and restaurants	3.5	3.7	3.3
- Manufacturing	5.6	6.6	5.3
- Construction	2.0	2.1	2.1
- Other	33.8	33.3	28.9
Total loan and advances to customers (gross)	98.2	100.9	92.0
Loan impairment provisions	(1.2)	(0.8)	(0.7)
Net loans and advances to customers	97.0	100.1	91.3
Total assets	149.5	150.5	133.5
Funded assets	149.5	150.5	133.5
Risk elements in lending	3.2	1.9	1.9
Provision coverage (3)	36%	43%	39%
Customer deposits (excluding repos)	98.0	97.9	88.9
Loan:deposit ratio (excluding repos)	99%	102%	103%
Risk-weighted assets			
- Credit risk (non-counterparty)	65.4	72.0	65.3
- Operational risk	6.4	6.5	7.0
Total risk-weighted assets	71.8	78.5	72.3

Notes:

- (1) Return on equity is based on segmental operating profit after tax adjusted for preference dividends divided by average notional equity based on 11% of the monthly average of segmental RWAs, assuming 28% tax rate.
- (2) Excluding restructuring costs and litigation and conduct costs.
- (3) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

Business review

Commercial Banking [continued](#)

Serving our customers

Commercial Banking's customer focused strategy is progressing well, with our Commercial NPS standing at +21, significantly ahead of our major UK bank competitors.

We continue to improve customer experience by becoming easier to do business with through operational investment, process simplification and digitisation. Account Opening improvements have reduced the end-to-end process by approximately seven days and customers can now take advantage of pre-approved loans of up to £50,000 through a self-service application process.

Our existing Bankline platform is used by 90% of our active customer base with over 400,000 payments processed every day. We continue to upgrade our new best-in-class Bankline, and have migrated around 25% of customers to the improved platform

In supporting UK business growth, we have opened our 12th Business Accelerator hub in London with our award winning Entrepreneurial Spark partnership, supporting over 3,800 companies to date. For the ninth year running, Lombard won the Business Moneyfacts Best Leasing and Asset Finance Provider Award (2009 to 2017).

Commercial Banking is helping our customers achieve their goals through the continued expansion of our innovative digital offering. We continue to scale ESME, our digital 24/7 online lending platform for SMEs, which has consistently high NPS scores over 70; we are building out a platform to help customers better understand contracts; and we are deploying Artificial Intelligence, such as embedding the new chatbot Cora into Bankline.

2017 compared with 2016

Operating profit of £1,108 million compared with £742 million in 2016, primarily reflecting a reduction in litigation and conduct costs. Adjusted operating profit(3) of £1,308 million, was £35 million, or 2.7%, higher than 2016 reflecting lower adjusted operating expenses and higher income, partially offset by higher impairments. Return on equity was 250 basis points higher than 2016 at 6.6%. Adjusted return on equity(3) remained broadly stable at 8.2%.

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Total income increased by £69 million, or 2.0%, to £3,484 million primarily reflecting increased volumes in targeted segments and re-pricing benefits on deposits. Net interest margin decreased by 2 basis points as active re-pricing of assets and deposits has been more than offset by wider asset margin pressure in a low rate environment.

Operating expenses decreased by £453 million to £2,014 million. Adjusted operating expenses(3) of £1,814 million, were £122 million, or 6.3%, lower than 2016, reflecting operating model simplification and productivity improvements, including a 16.4% reduction in front office headcount, and a £25 million intangible asset write-down in 2016. The cost:income ratio improved to 56.0% compared with 71.0% in 2016. Adjusted cost:income ratio(3) improved to 50.0% compared with 54.8% in 2016. Net impairment losses of £362 million were £156 million higher than 2016, reflecting a small number of single name impairments.

Net loans and advances decreased by £3.1 billion to £97.0 billion. Adjusting for transfers(1) of £1.8 billion, net loans and advances decreased by £4.9 billion to £97.0 billion, compared with 2016, as growth in targeted segments has been more than offset by active capital management of the lending book.

RWAs decreased by £6.7 billion to £71.8 billion. Adjusting for transfers(1) of £1.5 billion, RWAs decreased by £8.2 billion, or 10.4%, to £71.8 billion compared with 2016 reflecting active capital management of the lending book, achieving £12.5 billion of gross RWA reductions.

2016 compared with 2015

Operating profit was £742 million compared with £1,264 million in 2015 and included a £423 million litigation and conduct charge, principally relating to a provision in respect of the FCA review of RBS's treatment of SMEs. Adjusted operating profit(3) of £1,273 million, was £111 million, or 8%, lower than 2015, mainly reflecting increased impairments, partially offset by increased income.

Total income increased by £161 million to £3,415 million. Excluding the impact of transfers(2), a benefit of £218 million (2015 - £79 million), income increased by £21 million, or 1%, reflecting higher asset and deposit volumes. Net interest margin fell by 12 basis points to 1.76% driven by asset margin pressure in a competitive market and low rate environment.

Operating expenses increased by £546 million to £2,467 million. Adjusted operating expenses(3), excluding business transfers of £109 million (2015 - £25 million), increased by £51 million reflecting a £25 million intangible asset write-down and increased investment spend.

Net impairment losses increased by £137 million to £206 million primarily reflecting a single name charge taken in respect of the oil and gas portfolio.

Net loans and advances of £100.1 billion increased by £8.8 billion, or 10%, compared with 2015 reflecting increased borrowing across a number of sectors.

RWAs were £78.5 billion, an increase of £6.2 billion compared with 2015 reflecting asset growth partially offset by reduced RWA intensity.

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Notes:

- (1) Shipping and other activities which were formerly in Capital Resolution, were transferred from NatWest Markets on 1 October 2017, including net loans and advances to customers of £2.6 billion and RWAs of £2.1 billion. Commercial Banking transferred whole business securitisations and relevant financial institutions (RFI) to NatWest Markets during December 2017, including net loans and advances to customers of £0.8 billion and RWAs of £0.6 billion. Comparatives were not re-presented for these transfers.
- (2) The business transfers included impact on total income of £218 million (2015 - £79 million) and operating expenses of £109 million (2015 - £25 million).
- (3) Refer to income statement reconciliations on page 120.

Business review

Private Banking

	2017	2016	2015
Income statement	£m	£m	£m
Net interest income	464	449	436
Net fees and commissions	179	181	186
Other non-interest income	35	27	22
Non-interest income	214	208	208
Total income	678	657	644
Direct expenses			
- staff costs	(145)	(154)	(176)
- other costs	(32)	(44)	(35)
Indirect expenses	(268)	(313)	(307)
Restructuring costs			
- direct	(20)	(7)	(7)
- indirect	(25)	(30)	(66)
Litigation and conduct costs	(39)	(1)	(12)
Write down of goodwill			(498)
Operating expenses	(529)	(549)	(1,101)
Operating profit/(loss) before impairment (losses)/releases	149	108	(457)
Impairment (losses)/releases	(6)	3	(13)
Operating profit/(loss)	143	111	(470)
Operating expenses - adjusted (1)	(445)	(511)	(518)
Operating profit - adjusted (1)	227	149	113
Analysis of income by business			
Investments	119	97	86
Banking	559	560	558
Total income	678	657	644
Performance ratios			
Return on equity (2)	6.4%	5.6%	(27.7%)
Return on equity - adjusted (1,2)	11.3%	7.8%	4.9%
Net interest margin	2.47%	2.66%	2.75%
Cost:income ratio	78.0%	83.6%	171.0%
Cost:income ratio - adjusted (1)	65.6%	77.8%	80.4%
	2017	2016	2015
Capital and balance sheet	£bn	£bn	£bn
Loans and advances to customers (gross)			
- Personal	2.3	2.3	2.7
- Mortgages	8.2	7.0	6.5
- Other	3.0	2.9	2.0
Total loans and advances to customers (gross)	13.5	12.2	11.2
Total assets	20.3	18.6	17.0
Funded assets	20.3	18.5	17.0
Assets under management (3)	21.5	17.0	13.9

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Risk elements in lending	0.1	0.1	0.1
Provision coverage (4)	34%	30%	28%
Customer deposits (excluding repos)	26.9	26.6	23.1
Loan:deposit ratio (excluding repos)	50%	46%	48%
Risk-weighted assets			
- Credit risk (non-counterparty)	8.1	7.5	7.6
- Operational risk	1.0	1.1	1.1
Total risk-weighted assets	9.1	8.6	8.7

Notes:

- (1) Excluding restructuring costs and litigation and conduct costs and write down of goodwill.
- (2) Return on equity is based on segmental operating profit after tax adjusted for preference dividends divided by average notional equity based on 14% (15% prior to Q1 2017) of the monthly average of segmental RWAs, assuming 28% tax rate.
- (3) Comprises assets under management, assets under custody and investment cash.
- (4) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

Business review

Private Banking [continued](#)

Serving our customers

Private Banking continues to focus on delivering the best customer experience, with pro-active customer contact levels up 5% in the year. Our proposition has been extended to meet wider customer needs with the launch of new products, including the offset and 10-year tracker mortgages. The customer-centric strategy is improving returns and enhancing service levels, and we were awarded Best Private Bank in the UK at the Global Private Banking Awards 2017. Coutts was also awarded the Best Benefits or Loyalty Programme of the year for our Silk Card proposition and Best Debit Card Programme of the Year for our multi-currency debit card at the Card and Payments Awards 2018.

Private Banking has delivered top quartile investment performance on the majority of discretionary portfolios and UK multi-asset funds over the one, three and five year performance periods. Coutts won Gold Awards at the Portfolio Adviser Wealth Manager Awards 2018 for our Absolute Return portfolios and Cautious portfolios.

Investing in digital has seen the launch of Coutts Invest, a cost-effective, online investment solution, and delivery of an enhanced mobile experience for clients. Coutts won the Service Innovation Award at the Private Asset Manager Awards for the second consecutive year for client security innovations such as CouttsID and Behavioural Biometrics.

2017 compared with 2016

Operating profit increased by £32 million, or 28.8%, to £143 million compared with 2016 and return on equity increased from 5.6% to 6.4%. Adjusted operating profit(2) of £227 million was £78 million, or 52.3%, higher than 2016 primarily reflecting lower adjusted operating expenses and higher income. Adjusted return on equity(2) increased to 11.3% from 7.8% in 2016.

Total income increased by £21 million to £678 million. Adjusting for transfers(1) of £9 million, total income increased by £12 million to £678 million due to increased lending volumes and an £8 million gain on a property sale, partially offset by ongoing margin pressure. Net interest margin fell 19 basis points to 2.47% reflecting the competitive market and low rate environment.

Operating expenses decreased by £20 million to £529 million. Adjusted operating expenses(2) of £445 million decreased by £66 million, or 12.9%, compared with 2016 largely reflecting management actions to reduce costs, including an 11.8% reduction in front office headcount. The

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cost:income ratio improved to 78.0% from 83.6% in 2016. Adjusted cost:income ratio(2) improved to 65.6% compared with 77.8% in 2016.

Net loans and advances of £13.5 billion were £1.3 billion, or 10.7%, higher than 2016 principally driven by growth in mortgages.

Assets under management were £4.5 billion higher than 2016 at £21.5 billion. Adjusting for transfers(1) of £2.1 billion, assets under management were £2.4 billion, or 14.4%, higher than 2016 at £21.5 billion, reflecting both organic growth and favourable market conditions.

RWAs of £9.1 billion were £0.5 billion, or 5.8%, higher than 2016 primarily due to increased mortgage lending.

2016 compared with 2015

An operating profit of £111 million compared with an operating loss of £470 million in 2015 which included a goodwill impairment of £498 million. Adjusted operating profit(2) was £36 million, or 32%, higher than 2015 reflecting increased income, lower adjusted operating expenses and lower impairments.

Total income increased by £13 million to £657 million primarily reflecting higher asset volumes. Net interest margin fell by 9 basis points to 2.66% reflecting asset margin pressures.

Operating expenses of £549 million were £552 million, or 50% lower than 2015. Adjusted operating expenses(2) were £7 million, or 1%, lower than 2015 driven by reductions in the direct cost base, with employee numbers down 10%, partially offset by increased infrastructure costs absorbed following the sale of the international business.

Net loans and advances of £12.2 billion increased by £1.0 billion compared with 2015 driven by mortgages. Assets under management of £17.0 billion were £3.1 billion higher compared with 2015 reflecting underlying growth and equity index inflation. In addition, investment cash balances were included in assets under management for the first time in Q3 2016, excluding this, growth was £2.0 billion.

Notes:

(1) The UK PBB Collective Investment Funds (CIFL) business was transferred from UK PBB on 1 October 2017, including total income in Q4 2017 of £11 million and assets under management of £3.3 billion. Private Banking transferred Coutts Crown Dependencies (CCD) to RBS International during Q4 2017, including total income of £2 million and assets under management of £1.2 billion. Comparatives were not re-presented for these transfers.

(2) Refer to income statement reconciliations on page 120.

Business review

RBS International

	2017	2016	2015
Income statement	£m	£m	£m
Net interest income	325	303	303
Net fees and commissions	42	50	40
Other non-interest income	22	21	24
Non-interest income	64	71	64
Total income	389	374	367
Direct expenses			
- staff costs	(61)	(45)	(42)
- other costs	(25)	(17)	(16)
Indirect expenses	(116)	(107)	(98)
Restructuring costs			
- direct	(5)	(2)	
- indirect	(4)	(3)	(4)
Litigation and conduct costs	(8)		
Operating expenses	(219)	(174)	(160)
Operating profit before impairment losses	170	200	207
Impairment losses	(3)	(10)	
Operating profit	167	190	207
Operating expenses - adjusted (1)	(202)	(169)	(156)
Operating profit - adjusted (1)	184	195	211
Performance ratios			
Return on equity (2)	11.2%	13.8%	18.5%
Return on equity - adjusted (1,2)	12.6%	14.2%	18.9%
Net interest margin	1.36%	1.36%	1.48%
Cost:income ratio	56.3%	46.5%	43.6%
Cost:income ratio - adjusted (1)	51.9%	45.2%	42.5%
	2017	2016	2015
Capital and balance sheet	£bn	£bn	£bn
Loans and advances to customers (gross)			
- Corporate	5.7	6.2	4.5
- Mortgages	2.7	2.6	2.5
- Other	0.3		0.4
Total loans and advances to customers (gross)	8.7	8.8	7.4
Loan impairment provisions			(0.1)
Net loans and advances to customers	8.7	8.8	7.3
Total assets	25.9	23.4	23.1
Funded assets	25.9	23.4	23.1

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Risk elements in lending	0.1	0.1	0.1
Provision coverage (3)	35%	35%	34%
Customer deposits	29.0	25.2	21.3
Loan:deposit ratio (excluding repos)	30%	35%	35%
Risk-weighted assets			
- Credit risk (non-counterparty)	4.4	8.8	7.6
- Operational risk	0.7	0.7	0.7
Total risk-weighted assets	5.1	9.5	8.3

Notes:

(1) Excluding restructuring costs.

(2) Return on equity is based on segmental operating profit after tax adjusted for preference dividends divided by average notional equity based on 16% (12% prior to November 2017) of the monthly average of segmental RWAs, assuming 10% tax rate.

(3) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

Business review

RBS International continued

Serving our customers

RBS International continues to focus on meeting more of our retail, commercial, corporate and financial institution customers' needs. We are nearing the final stages of our transition to becoming a non ring-fenced bank, and during 2017 we opened new wholesale branches in Luxembourg and London, supporting our financial institution customers in these important funds banking jurisdictions.

Across our personal banking propositions we continue to maintain our position as market leader in the Isle of Man and top three market positions in Guernsey and Jersey. To better meet our personal customers' savings needs, we delivered a new suite of fixed term deposits. At the same time we have supported over 1,900 customers buy new homes, exceeding £480 million of new mortgages.

Outside of our home jurisdictions, we have taken action to meet more of the international needs of our customers. Our mobile app now averages over one million log-ins per month, and has been upgraded to open access to international customers, assisting in our 14% increase in users.

For our commercial, corporate and financial institution customers, we invested into the next generation of our agile eQ multi-currency electronic banking platform, which brings enhanced payment functionality and product suite. To meet our non-personal customers savings needs, we delivered a new Notice Account at the beginning of August 2017, and our customers responded by depositing over £1 billion into the account.

2017 compared with 2016

Operating profit of £167 million decreased by £23 million, or 12.1%, compared with 2016 and return on equity decreased to 11.2% from 13.8%, reflecting increased operational costs associated with the creation of a bank outside the ring-fence, partially offset by higher income. Return on equity decreased to 11.2% from 13.8%. Adjusted return on equity(1) decreased to 12.6% from 14.2% in 2016 and adjusted cost:income ratio of 51.9% increased from 45.2% in 2016.

Total income increased by £15 million, or 4.0%, to £389 million driven by increased average lending balances in 2017 and re-pricing benefits on the deposit book.

Net loans and advances were broadly stable compared with 2016 and customer deposits increased by £3.8 billion to £29.0 billion primarily reflecting increased short term placements in the Funds sector. RWAs of £5.1 billion reduced by £4.4 billion, or 46.3%, compared with 2016, reflecting the benefit of receiving the Advanced Internal Rating Based Waiver on the wholesale corporate book in November 2017, in advance of becoming a bank outside the ring-fence.

From 1st Jan 2018 RBS International will include the funds and trustee depositary business transferred from Commercial Banking, which generated around £150 million of income and £60 million of costs in 2017.

2016 compared with 2015

Operating profit decreased by £17 million to £190 million principally reflecting increased impairment losses and operating expenses. Adjusted operating profit⁽¹⁾ was £195 million, £16 million lower than 2015.

Total income increased by £7 million to £374 million primarily reflecting higher asset volumes. Net interest margin fell by 12 basis points to 1.36% reflecting asset margin pressures.

Operating expenses of £174 million were £14 million, or 9% higher than 2015. Adjusted operating expenses⁽¹⁾ were £13 million, or 8%, higher than 2015, reflecting a number of one-off charges.

A net impairment loss of £10 million was reported in 2016.

Net loans and advances of £8.8 billion increased by £1.5 billion compared with 2015 reflecting balance draw-downs in the corporate lending portfolio, mainly within the Funds sector.

Customer deposits of £25.2 billion grew by £3.9 billion compared with 2015 principally reflecting the transfer of the Luxembourg branch into RBSI from former Capital Resolution during Q2 2016.

RWAs were £9.5 billion, an increase of £1.2 billion compared with 2015 reflecting asset growth.

Note:

(1) Refer to income statement reconciliations on page 120.

Business review

NatWest Markets

	2017	2016	2015
	£m	£m	£m
Income statement			
Net interest income	203	343	452
Net fees and commissions	114	141	484
Income from trading activities	582	829	743
Own credit adjustments	(66)	187	295
Strategic disposals	26	(81)	(38)
Other operating income/(loss)	191	(207)	130
Non-interest income	847	869	1,614
Total income	1,050	1,212	2,066
Direct expenses			
- staff costs	(677)	(358)	(644)
- other costs	(287)	(119)	(324)
Indirect expenses	(564)	(1,607)	(2,038)
Restructuring costs			
- direct	(319)	(75)	(424)
- indirect	(117)	(115)	(1,407)
Litigation and conduct costs	(237)	(550)	(404)
Operating expenses	(2,201)	(2,824)	(5,241)
Operating loss before impairment releases/(losses)	(1,151)	(1,612)	(3,175)
Impairment releases/(losses)	174	(253)	730
Operating loss	(977)	(1,865)	(2,445)
Of which:			
Core operating profit/(loss)	41	(386)	(837)
Legacy operating loss	(1,018)	(1,479)	(1,608)
Total income - adjusted (1)	1,090	1,106	1,809
Operating expenses - adjusted (2)	(1,528)	(2,084)	(3,006)
Operating loss - adjusted (1,2)	(264)	(1,231)	(467)
Analysis of income by product			
Rates	985	837	792
Currencies	470	551	391
Financing	456	344	363
Revenue share paid to other segments	(246)	(211)	(237)
Businesses transferred to Commercial Banking			98
Core income excluding OCA	1,665	1,521	1,407
Legacy	(575)	(415)	402
Total income - adjusted	1,090	1,106	1,809
Own credit adjustments	(66)	187	295
Strategic disposals	26	(81)	(38)
Total income	1,050	1,212	2,066
Performance ratios			
Return on equity (3)	(9.0%)	(12.5%)	(11.2%)
Return on equity - adjusted (1,2,3)	(3.7%)	(8.7%)	(3.0%)
Net interest margin	0.65%	0.91%	0.59%
Cost:income ratio	nm	nm	nm

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Cost:income ratio - adjusted (1,2)	140.2%	188.4%	166.2%
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nm = not meaningful

Notes:

- (1) Excluding own credit adjustments and strategic disposals.
- (2) Excluding restructuring costs and litigation and conduct costs.
- (3) Return on equity is based on segmental operating profit after tax adjusted for preference dividends divided by average notional equity (based on 15% of the monthly average of segmental risk-weighted assets incorporating the effect of capital deductions (RWAs)), assuming 28% tax rate.

Business review

NatWest Markets *continued*

	2017	2016	2015
	£bn	£bn	£bn
Capital and balance sheet			
Net loans and advances to customers (excluding reverse repos)	22.7	30.2	39.7
Loans and advances to banks (excluding reverse repos) (1)	7.5	7.9	12.8
Reverse repos	38.6	38.8	38.9
Securities	25.5	25.3	29.9
Cash and eligible bills	19.3	18.1	27.4
Other	5.1	8.2	8.0
Total assets	277.9	372.5	416.8
Funded assets	118.7	128.5	156.7
Customer deposits (excluding repos)	14.8	17.9	31.7
Bank deposits (excluding repos)	13.0	21.3	21.4
Repos	28.4	27.3	35.2
Debt securities in issue	5.1	6.7	7.6
Loan:deposit ratio (excluding repos)	153%	169%	125%
Risk-weighted assets			
- Credit risk			
- non-counterparty	16.1	23.7	32.3
- counterparty	15.3	22.8	23.3
- Market risk	16.2	16.4	19.5
- Operational risk	5.3	6.8	7.0
Total risk-weighted assets	52.9	69.7	82.1
Of which:			
Core RWAs	32.3	35.2	33.1
Legacy RWAs ex Alawwal	14.0	26.6	42.1
Alawwal	6.6	7.9	6.9

Note:

(1) Excludes disposal groups.

Business review

NatWest Markets *continued*

Serving our customers

NatWest Markets has put customers at the centre of the way it does business. Since 2015 NatWest Markets has focused on the core products and markets where it has a strong track record, longstanding relationships and market leading positions. NatWest Markets is making strong progress with its multi-year transformation to build a business focused on delivering sustainable returns.

Following the closure of the former Capital Resolution business in 2017, NatWest Markets now includes legacy run-off assets alongside its core businesses. The business continues to focus on customer service and trust in its core markets and technology is enhancing the way NatWest Markets provides financial solutions to its customers. This is demonstrated by a number of industry awards and rankings:

- No.1 for Gilts by Market Share EMEA FIs (Source: Greenwich Associates, European Fixed Income 2017 Government Bonds)
- No.1 for FX Service Quality UK Corporates (Source: Greenwich Associates, European FX 2017)
- Best bank for FX Prime Brokerage services (Source: FX Week Best Bank Awards 2017)
- Best bank for FX Post-Trade Services (Source: FX Week Best Bank Awards 2017)
- Top 2 for all European issuers in the Private Placement market (Source: Dealogic Private Placement Report, Full Year 2017)
- Top 3 for GBP Denominated DCM in EMEA (Source: Dealogic EMEA Review, Full Year 2017)

2017 compared with 2016

An operating loss of £977 million compared with £1,865 million in 2016. The core business operating profit increased by £427 million to £41 million reflecting lower litigation and conduct costs and higher income, partially offset by increased restructuring costs reflecting back office restructuring activity. Adjusted operating loss(1) of £264 million, compared with £1,231 million in 2016, reflecting lower adjusted costs(1) and a net impairment release of £174 million in 2017, compared with a charge of £253 million in 2016.

Total income of £1,050 million compared with £1,212 million in 2016. In the core business, total income increased by £42 million, or 2.7%, to £1,616 million, whereas adjusted income(1) increased by £144 million, or 9.5%, to £1,665 million, principally driven by Rates as the business navigated markets well despite a lower level of customer activity than in 2016, which benefited from favourable market conditions following the EU referendum.

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Operating expenses of £2,201 million were £623 million, or 22.1%, lower than 2016, whereas adjusted operating expenses(1) of £1,528 million were £556 million, or 26.7%, lower than 2016. In the legacy business, operating expenses decreased by £238 million, or 27.5%, to £627 million, whereas adjusted operating expenses(1) decreased significantly reflecting a 77.7% reduction in headcount as the business moved towards closure. In the core business, operating expenses decreased by £383 million, 19.5%, to £1,577 million as the business continues to drive cost reductions, where as adjusted operating expenses(1) were £1,268 million compared to £1,320 million in 2016.

RWAs decreased by £15.3 billion, adjusting for transfers(2), to £52.9 billion primarily reflecting reductions in the legacy business. In the core business RWAs decreased by £3.1 billion to £32.3 billion reflecting lower counterparty credit risk through mitigation activities and business initiatives. At the end of 2017 the legacy business within NatWest Markets had RWAs of £14.0 billion, excluding RBS's stake in Alawwal Bank, a reduction of £10.9 billion, adjusting for transfers(2), over the course of the year.

Total assets fell by £94.6 billion to £277.9 billion, funded assets fell to £118.7 billion, a reduction of £7.3 billion, adjusting for transfers(2), mainly reflecting disposal activity.

2016 compared with 2015

An operating loss of £1,865 million compared with an operating loss of £2,445 million in 2015 primarily driven by lower income and increased impairments partially offset by lower operating expenses. The adjusted operating loss(1) was £1,231 million compared with a loss of £467 million in 2015.

Total income decreased by £854 million to £1,212 million. Total income in the Core business increased by £47 million, or 3.1%, to £1,574 million, whereas adjusted income(1) increased by £114 million, or 8.1%, to £1,521 million. The increase was driven by Rates and Currencies, reflecting sustained customer activity throughout the year and favourable market conditions following the EU referendum and subsequent central bank actions. Income in the legacy business decreased due to the disposal losses of £572 million, £205 million higher than 2015, including £259 million in respect of the shipping portfolio. In addition, the Legacy business also incurred a funding valuation adjustment charge of £170 million in 2016.

Operating expenses decreased from £5,241 million to £2,824 million in 2016, driven by lower restructuring costs, primarily reflecting a 1,000 reduction in headcount in the Legacy business.

Total assets decreased by £44.3 billion to £372.5 billion, funded assets decreased by £28.2 billion compared with 2015 to £128.5 billion, mainly reflecting disposal activity.

RWAs decreased by £12.4 billion compared with 2015 to £69.7 billion reflecting disposal activity partially offset by business movements and the impact of the weakening of sterling.

Notes:

(1) Refer to income statement reconciliations on page 120.

(2) Shipping and other activities which were formerly in Capital Resolution, were transferred to Commercial Banking on 1 October 2017, including total funded assets of £3.3 billion, net loans and advances to customers of £2.6 billion, and RWAs of £2.1 billion. Whole business securitisations and relevant financial institutions (RFI) were transferred from Commercial Banking during December 2017, including net loans and advances to customers of £0.8 billion, and RWAs of £0.6 billion. Comparatives were not re-presented for these transfers.

Business review

Central items & other

	2017 £m	2016 £m	2015 £m
Central items not allocated	(483)	(5,006)	(2,982)

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

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

2017 compared with 2016

Central items not allocated represented a charge of £483 million in 2017, compared with a £5,006 million charge in 2016, and included litigation and conduct costs of £589 million, compared with £4,088 million in 2016. Treasury funding costs were a charge of £58 million, compared with a charge of £94 million in 2016. Restructuring costs in the year included £94 million relating to the former Williams & Glyn business, compared with £1,399 million in 2016. In addition to a VAT recovery of £86 million, compared with £227 million in 2016, a £156 million gain on the sale of Vocalink and a £135 million gain in relation to the sale of EuroClear(1).

2016 compared with 2015

Central items not allocated represented a charge of £5,006 million in 2016, compared with a £2,982 million charge in 2015, and included restructuring costs of £1,482 million and litigation and conduct costs of £4,088 million. Restructuring costs included a £750 million provision in respect of the 17 February 2017 update on RBS's remaining State Aid obligation regarding the business previously described as Williams & Glyn. Treasury funding costs were a charge of £94 million, compared with a gain of £169 million in 2015, and included a £510 million charge for volatile items under IFRS, due to reductions in long term interest rates, and a £349 million foreign exchange gain, principally associated with the weakening of sterling against the US dollar. In addition, there was a £126 million loss on redemption of own debt in 2016. These were partially offset by a VAT recovery of £227 million and a £246 million gain on the sale of the stake in VISA Europe.

Note:

(1) The total gain in relation to the sale of Euroclear was £161 million, of which £135 million central items and £26 million NatWest Markets.

Capital and risk management

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Presentation of information

Except as otherwise indicated, information in the Capital and risk management section (pages 151 to 330) is within the scope of the Independent auditor's report.

Business review **Capital and risk management**

Risk management framework (unaudited)

Introduction

RBS operates an integrated risk management framework, centred around the embedding of a strong risk culture, which is designed to achieve the correct balance between prudential and conduct obligations. Each element of the risk management framework functions both individually and as part of a larger continuum. The framework ensures the tools and capability are in place to facilitate risk management and decision-making across the organisation.

RBS's strategy is informed and shaped by an understanding of the risk landscape, including a range of significant risks and uncertainties in the external economic, political and regulatory environment. Identifying these risks and understanding how they affect RBS informs risk appetite and risk management practice.

Risk appetite, which is supported by a robust set of principles, policies and practices, defines our levels of tolerance for a variety of risks.

It is a key element of RBS's risk management framework and culture, providing a structured approach to risk-taking within agreed boundaries.

Effective governance, underpinned by our three lines of defence model is essential to ensure the right decisions are being made by the right people at the right time. Governance includes regular and transparent risk reporting as well as discussion and decision-making at senior management committees, which informs management strategies across the organisation.

RBS aims to have the right tools in place to support effective risk management. Having the appropriate capability, people and infrastructure is central. This is supported by a strong emphasis on systems, training and development to ensure threats are anticipated and managed appropriately within the boundaries determined by the agreed risk appetite.

Measurement, evaluation and transparency are also fundamental elements of the framework, providing robust analysis of the materiality and likelihood of specific threats as well as supporting understanding and communication of the financial and non-financial risks RBS is exposed to.

RBS has a strong focus on defining the control environment to ensure the effective operation of policies and processes embedded in the customer-facing businesses, thus facilitating the management of the risks they take in the course of their day-to-day activities.

Business review **Capital and risk management**

Risk management framework (unaudited) **continued**

RBS also has a strong focus on continually improving the way risk is managed, particularly in terms of how threats are anticipated or responded to, but also in terms of simplifying or enhancing existing controls, policies and practice.

Essential to this is the ability to scan both the medium- and long-term horizon for risks. Stress testing is used to quantify, evaluate and understand the potential impact that changes to risks may have on the financial strength of RBS, including its capital position. In turn, the results of stress tests can be used to inform and shape strategy.

Given the evolving external landscape, including the structural reform required by the UK's ring-fencing requirements, in 2017 there was an emphasis on enhancing both the risk culture and risk appetite elements of the framework – as well as the interconnectivity between framework components.

All RBS employees share ownership of the way risk is managed. The businesses, the control and support functions, and Internal Audit work together to make sure business activities and policies are consistent with risk appetite; following the three lines of defence model. RBS constantly monitors its risk profile against its defined risk appetite and limits, taking action when required to balance risk and return.

Risk culture

A strong risk culture is essential if RBS is to achieve its ambition to build a truly customer-focused bank. RBS's risk culture target is to make risk simply part of the way that employees work and think.

Such a culture must be built on strong risk practices and appropriate risk behaviours must be embedded throughout the organisation.

To achieve this, RBS is focusing on leaders as role models and taking action to build clarity, continuing to develop capability and motivate employees to reach the required standards of risk culture behaviour, including:

- Taking personal accountability and proactively managing risk.
- Respecting risk management and the part it plays in daily work.
- Understanding clearly the risks associated with individual roles.

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- Aligning decision-making to RBS's risk appetite.
- Considering risk in all actions and decisions.
- Escalating risks and issues early.
- Taking action to mitigate risks.
- Learning from mistakes and near-misses.
- Challenging others' attitudes, ideas and actions.
- Reporting and communicating risks transparently.

To embed and strengthen the required risk culture, a number of RBS-wide activities were undertaken in 2017. These included ethical scenario training, mandatory Group Policy Learning, and Managing Our Performance meetings designed to enhance risk culture at a team and individual employee level.

To support a consistent tone from the top, senior management regularly communicate the importance of the required risk behaviours, linking them to the achievement of good customer outcomes.

RBS's target risk culture behaviours have now been embedded into Our Standards. These are clearly aligned to the core values of serving customers, working together, doing the right thing and thinking long term. They act as a clear starting point for a strong and effective risk culture because Our Standards are used for performance management, recruitment and selection and development.

Risk culture behaviour assessment is incorporated into performance assessment and compensation processes for enhanced governance staff. In Q1 2017, an objective aligned to RBS's risk culture target was set for the Executive Committee. Activity against that objective over the year was integral to performance reviews.

A risk culture measurement and reporting framework has been developed, enabling RBS to benchmark both internally and externally. The purpose of the framework is to assess progress in embedding RBS's target risk culture where risk is simply part of the way we work and think. In 2017, external validation indicated that good progress had been made against that objective demonstrating that the continued focus and actions are moving RBS towards its target risk culture.

Risk-based key performance indicators

RBS-wide remuneration policy ensures that the remuneration arrangements for all employees reflect the principles and standards prescribed by the PRA rulebook and the FCA handbook.

Training

Enabling employees to have the capabilities and confidence to manage risk is core to RBS's learning strategy.

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RBS offers a wide range of risk learning, both technical and behavioural, across the risk disciplines. This training can be mandatory, role-specific or for personal development.

Mandatory learning for all staff is focused on keeping employees, customers and RBS safe. This is easily accessed online and is assigned to each person according to their role and business area. The system allows monitoring at all levels to ensure completion.

Code of Conduct

Aligned to RBS's values is the Code of Conduct (Our Code). The code provides guidance on expected behaviour and sets out the standards of conduct that support the values. It explains the effect of decisions that are taken and describes the principles that must be followed.

Business review **Capital and risk management**

Risk management framework (unaudited) [continued](#)

These principles cover conduct-related issues as well as wider business activities. They focus on desired outcomes, with practical guidelines to align the values with commercial strategy and actions. The embedding of these principles facilitates sound decision-making and a clear focus on good customer outcomes. They are also consistent with the people management and remuneration processes and support a positive and strong risk culture through appropriate remuneration structures.

A simple decision-making guide – the YES check – has been included in the Code of Conduct. It is a simple set of five questions, designed to ensure RBS values guide day-to-day decisions:

- Does what I am doing keep our customers and RBS safe and secure?
- Would customers and colleagues say I am acting with integrity?
- Am I happy with how this would be perceived on the outside?
- Is what I am doing meeting the standards of conduct required?
- In five years' time would others see this as a good way to work?

Each of the five questions is a prompt to think about how the situation fits with RBS Group's values. It ensures that employees can think through decisions that do not have a clear answer, and guides their judgements.

If conduct falls short of RBS's required standards, the accountability review process is used to assess how this should be reflected in pay outcomes for those individuals concerned. RBS's approach to remuneration and related policies promotes effective risk management through a clear distinction between fixed remuneration – which reflects the role undertaken by an individual – and variable remuneration, which is directly linked to, and reflects performance and can be risk-adjusted. The Group Performance & Remuneration Committee considers risk performance and conduct when determining overall bonus pools. Such pay decisions aim to reinforce the need for all employees to demonstrate acceptable risk management practice.

Risk governance

Committee structure

The diagram illustrates the risk committee structure in 2017 and the main purposes of each committee.

Note:

(1) The IFRS 9 Metrics Oversight Committee has delegated authority from the Provisions Committee to approve the Significant Deterioration framework, the data rules for missing variables, materiality decisions relating to the expected credit loss calculation, adjustments relating to the expected credit loss calculation if necessary, and changes in expected credit loss provision calculation methodology.

Business review **Capital and risk management**

Risk management framework (unaudited) [continued](#)

[Risk management structure](#)

The diagram illustrates RBS' s risk management structure in 2017 and key risk management responsibilities.

Notes:

(1) RBS risk management framework

In 2017, the Chief Risk Officer (CRO) led Risk, Conduct & Restructuring. The CRO reported directly to the Chief Executive and had a dotted reporting line to the Board Risk Committee, as well as a right of access, to the chairman of the Board Risk Committee.

Risk, Conduct & Restructuring was a function independent of the franchises, structured by risk discipline to facilitate the effective management of risk.

Risk, Conduct & Restructuring was organised into eight functional areas: Chief of Staff; Credit Risk; Restructuring; Enterprise-Wide Risk; Risk & Conduct Infrastructure; Operational Risk; Risk & Conduct Assurance; and Financial Crime. There were also Directors of Risk & Conduct/Chief Risk Officers for each of the franchises and for Services.

Risk committees in the customer businesses and key functional risk committees oversaw risk exposures arising from management and business activities and focused on ensuring that they were adequately monitored and controlled.

(2) Regulatory Affairs

In 2017, Regulatory Affairs was responsible for providing leadership of RBS's relationships with its regulators. Regulatory Affairs is part of Corporate Governance & Regulatory Affairs. Remediation & Complaints reports to the Services Chief Operating Officer.

Business review **Capital and risk management**

Risk management framework (unaudited) *continued*

Three lines of defence

RBS uses the three lines of defence model to articulate accountabilities and responsibilities for managing risk across the organisation. The three lines of defence model is adopted across the industry to support the embedding of effective risk management and is expressed through a set of principles as outlined below:

First line of defence *Management and supervision*

The first line of defence includes customer franchises, Technology and Services as well as support and control functions such as Human Resources, Communications & Marketing and Finance. Responsibilities include:

- Owning, managing and supervising, within a defined risk appetite, the risks which exist in business areas and support functions.
- Ensuring appropriate controls are in place to mitigate risk, balancing control, customer service and competitive advantage.
- Ensuring that the culture of the business supports balanced risk decisions and compliance with policy, laws and regulations.
- Ensuring the business has effective mechanisms for identifying, reporting and managing risk and controls.

Second line of defence *Oversight and control*

The second line of defence includes Risk, Conduct & Restructuring, RBS Legal, and the financial control element of RBS's Finance function. Responsibilities include:

- Working with the businesses and functions to develop risk and control policies, limits and tools for the business to use in order to discharge its responsibilities.
- Overseeing and challenging the management of risks and controls.
- Leading the articulation, design and development of risk culture and appetite.
- Analysing the aggregate risk profile and ensuring that risks are being managed within risk appetite.
- Providing expert advice to the business on risk management.
- Providing senior executives with relevant management information and reports, and escalating concerns where appropriate.

Third line of defence Internal Audit

Responsibilities include:

- Providing assurance to the Group Audit Committee that the main business risks have been identified and effective controls are in place to manage these risks.
- Engaging with management to provide perspectives, insights and challenge in order to influence the building of a sustainable bank.
- Providing independent assurance to the Financial Conduct Authority, Prudential Regulation Authority, Central Bank of Ireland and other key jurisdictional regulators on specific risks and controls.

Risk appetite

Risk capacity defines the maximum level of risk RBS can assume before breaching constraints determined by regulatory capital and liquidity needs, the operational environment, and from a conduct perspective. Articulating risk capacity helps determine where risk appetite should be set, ensuring there is a buffer between internal risk appetite and RBS's ultimate capacity to absorb losses.

Risk appetite defines the level and types of risk RBS is willing to accept, within risk capacity, in order to achieve strategic objectives and business plans. It links the goals and priorities to risk management in a way that guides and empowers staff to serve customers well and achieve financial targets.

Risk appetite framework

The risk appetite framework bolsters effective risk management by promoting sound risk-taking through a structured approach, within agreed boundaries. It also ensures emerging risks and risk-taking activities that would be out of appetite are identified, assessed, escalated and addressed in a timely manner.

To facilitate this, a detailed annual review of the framework is carried out. The review includes:

- Assessing the adequacy of the framework when compared to internal and external expectations.
- Ensuring the framework remains effective as a strong control environment for risk appetite.
- Assessing the level of embedding of risk appetite across the organisation.

The Board approves the risk appetite framework annually.

Business review **Capital and risk management**

Risk management framework (unaudited) [continued](#)

[Establishing risk appetite](#)

The effective communication of risk appetite is essential in embedding appropriate risk-taking into RBS's culture.

Risk appetite is communicated across RBS through risk appetite statements. The risk appetite statements provide clarity on the scale and type of activities that can be undertaken in a manner that is easily conveyed to staff.

Risk appetite statements consist of qualitative statements of appetite supported by risk limits and triggers that operate as a defence against excessive risk-taking. They are established at RBS-wide level for all strategic risks and material risks, and at legal entity, franchise, and function level for all other risks.

The annual process of establishing risk appetite statements is completed alongside the business and financial planning process. This ensures plans and risk appetite are appropriately aligned.

The Board sets risk appetite for our most material risks to help ensure RBS is well placed to meet its priorities and long-term targets even under challenging economic environments. It is the basis on which RBS remains safe and sound while implementing its strategic business objectives.

RBS's risk profile is frequently reviewed and monitored to ensure it remains within appetite and that management focus is concentrated on all strategic risks, material risks and emerging risk issues. Effective processes are in place for reporting risk profile relative to risk appetite to the Board and senior management.

Risk control frameworks and limits

Risk control frameworks and their associated limits are an integral part of the risk appetite framework and a key part of embedding risk appetite in day-to-day risk management decisions. The risk control frameworks manage risk by expressing a clear tolerance for material risk types that is aligned to business activities.

The RBS policy framework directly supports the qualitative aspects of risk appetite, helping to rebuild and maintain stakeholder confidence in RBS's risk control and governance. Its integrated approach is designed to ensure that appropriate controls, aligned to risk appetite, are set for each of the strategic and material risks it faces, with an effective assurance process put in place to monitor and report on performance.

Risk identification and measurement

Risk identification and measurement within the risk management process comprise:

- Regular assessment of the overall risk profile, incorporating market developments and trends, as well as external and internal factors.
- Monitoring of the risks associated with lending and credit exposures.
- Assessment of trading and non-trading portfolios.
- Review of potential risks in new business activities and processes.
- Analysis of potential risks in any complex and unusual business transactions.

RBS has developed a risk directory which contains details of the financial and non-financial risks that it faces each day. It provides a common risk language to ensure consistent terminology is used across RBS. The risk directory is subject to annual review. This ensures that the directory continues to provide a comprehensive and meaningful list of the inherent risks within the businesses.

Risk treatment and mitigation

Risk treatment and mitigation is an important aspect of ensuring that risk profile remains within risk appetite. Risk mitigation strategies are discussed and agreed with the businesses.

When evaluating possible strategies, costs and benefits, residual risks (risks that are retained) and secondary risks (those caused by the risk mitigation actions) are considered. Monitoring and review processes are in place to track results.

Information about regulatory developments and discussions is communicated to each customer-facing business and function. This helps identify and execute any required mitigating changes to strategy or to business models.

Early identification and effective management of changes in legislation and regulation are critical to the successful mitigation of conduct and regulatory risk. The effects of all changes are managed to ensure timely compliance readiness. Changes assessed as having a high or medium-high impact are managed closely.

Business review **Capital and risk management**

Risk management framework (unaudited) **continued**

Top and emerging risks that may affect future results and performance are reviewed and monitored. Action is taken to mitigate potential risks as and when required. In depth analysis is carried out, including the stress testing of exposures relative to the risk.

The Board Risk Committee, Asset & Liability Management Committee and Executive Risk Forum provide governance and oversight.

Risk and conduct assurance

Risk & Conduct Assurance is an independent second line of defence function which provides assurance to both internal and external stakeholders including the Board, senior management, risk functions, franchises, Internal Audit and regulators.

The function has three main elements – assurance, model risk and risk culture. Risk & Conduct Assurance teams perform quality assurance on targeted credit, market, financial crime and conduct risk activities. They also review selected key controls and manage model risk governance and validation activities. In addition, the Head of Risk & Conduct Assurance oversees the delivery of work to embed and strengthen RBS's desired risk culture.

The Head of Risk & Conduct Assurance also oversees the three lines of defence model, including relevant principles. For further information refer to page 156.

Assurance

Qualitative reviews are carried out to assess various risk aspects as appropriate, including: the quality of risk portfolios, the accuracy of the Basel Model Inputs and related probability of default/loss given default classifications, the quality of risk management practices, policy compliance and adherence to risk appetite. This can include testing the bank's credit portfolios and market risk exposures to assist in early identification of emerging risks, as well as undertaking targeted reviews to examine specific concerns raised either by these teams or by their stakeholders.

The adequacy and effectiveness of selected key controls owned and operated by the Risk function are also tested (with a particular focus on credit risk and market risk controls). The team's remit includes selected controls within the scope of Section 404 of the US Sarbanes-Oxley Act 2002 as well as selected controls supporting risk data aggregation and reporting.

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Assurance is carried out on Anti-Money Laundering, Sanctions, and Anti-Bribery & Corruption processes and controls. This helps inform whether or not the financial crime control environment is adequate and effective and whether financial crime risk is appropriately identified, managed and mitigated. Assurance of conduct policies is predominantly focused on the Risk, Conduct & Restructuring-owned conduct policies. Targeted work is also carried out to assist RBS in meeting its promises to customers as well as its regulatory requirements.

The Risk & Conduct Assurance Committee ensures a consistent and fair approach to all aspects of the team's assurance review activities. The committee also monitors and validates the ongoing programme of reviews and tracks the remediation of the more material review actions.

Model risk

Model risk is the risk that a model is specified incorrectly (not achieving the objective for which it is designed), implemented incorrectly (an error in translating the model specification into the version actually used), or being used incorrectly (correctly specified but applied inappropriately).

RBS uses a variety of models as part of its risk management process and activities. Key examples include the use of model outputs to support risk assessments in the credit approval process, ongoing credit risk management, monitoring and reporting, as well as the calculation of risk-weighted assets. Other examples include the use of models to measure market risk exposures and calculate associated capital requirements, as well as for the valuation of positions. The models used for stress-testing purposes also play a key role in ensuring RBS holds sufficient capital, even in stressed market scenarios.

Model Risk Governance

Model Risk Governance is responsible for setting policy and providing a governance framework for all of RBS's models and related processes. It is also responsible for defining and monitoring model risk appetite in conjunction with model owners and model users, monitoring the model risk profile and reporting on the model population as well as escalating issues to senior management, through the Model Risk Forum, and the respective franchise and function risk committees.

Model Risk Management

Model Risk Management performs independent model validation for material models. It works with individual businesses and functions to monitor adherence to model risk standards, ensuring that models are developed and implemented appropriately and that their operational environment is fit for purpose.

Model Risk Management performs reviews of relevant risk and pricing models in two instances: (i) for new models or amendments to existing models and (ii) as part of its ongoing programme to assess the performance of these models.

Model Risk Management reviews may test and challenge the logic and conceptual soundness of the methodology, or the assumptions underlying a model. Reviews may also test whether or not all appropriate risks have been sufficiently captured as well as checking the accuracy and robustness of calculations. Based on the review and findings from Model Risk Management, RBS's model or risk committees consider whether a model can be approved for use. Models used for regulatory reporting may additionally require regulatory approval before implementation.

Business review Capital and risk management

Risk management framework (unaudited) continued

Model Risk Management reassesses the appropriateness of approved risk models on a periodic basis. Each periodic review begins with an initial assessment. Based on the initial assessment, an internal model governance committee will decide to re-ratify a model or to carry out additional work. In the initial assessment, Model Risk Management assesses factors such as a change in the size or composition of the portfolio, market changes, the performance of or any amendments to the model and the status of any outstanding issues or scheduled activities carried over from previous reviews.

Model Risk Management also monitors the performance of RBS's portfolio of models to ensure that they appropriately capture underlying business rationale.

For more specific information relating to market risk models and pricing models, refer to page 220.

Stress testing: capital management

Stress testing is a key risk management tool and a fundamental component of RBS's approach to capital management. It is used to quantify, evaluate and understand the potential impact of specified changes to risk factors on the financial strength of RBS, including its capital position. Stress testing includes:

- Scenario testing, which examines the impact of a hypothetical future state to define changes in risk factors; and
- Sensitivity testing, which examines the impact of an incremental change to one or more risk factors.

The process for stress testing consists of four broad stages:

- Define scenarios
 - Assess impact
- Identify RBS-specific vulnerabilities and risks.
 - Define and calibrate scenarios to examine risks and vulnerabilities.
 - Formal governance process to agree scenarios.
 - Translate scenarios into risk drivers.
 - Assess impact to positions, income and costs.

- Impact assessment captures input from across RBS.
 - Aggregate impacts into overall results.
 - Results form part of risk management process.
 - Scenario results are used to inform RBS's business and capital plans.
 - Scenario results are analysed by subject matter experts and appropriate management actions are then developed.
 - Scenario results and management actions are reviewed and agreed by senior management through executive committees including Executive Risk Forum, Board Risk Committee and the Board.
- Calculate results and assess implications
Develop and agree management actions

Stress testing is used widely across RBS. Key areas are summarised in the diagram below:

Specific areas that involve capital management include:

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- 1) *Strategic financial and capital planning*: through assessing the impact of sensitivities and scenarios on the capital plan and capital ratios.
- 2) *Risk appetite*: through gaining a better understanding of the drivers of and the underlying risks associated with risk appetite.
- 3) *Risk identification*: through a better understanding of the risks that could potentially impact RBS's financial strength and capital position.
- 4) *Risk mitigation*: through identifying actions that can be taken to mitigate risks, or could be taken, in the event of adverse changes to the business or economic environment. Risk mitigation is substantially supplemented through RBS's recovery plan.

Regular reverse stress testing is also carried out. This examines circumstances that can lead to specific, defined outcomes such as business failure. Reverse stress testing allows RBS to examine potential vulnerabilities in its business model more fully.

Business review **Capital and risk management**

Risk management framework (unaudited) *continued*

Capital sufficiency: going concern forward-looking view

Going concern capital requirements are examined on a forward-looking basis including as part of the annual budgeting process by assessing the resilience of capital adequacy and leverage ratios under hypothetical future states. A range of future states are examined. In particular, capital requirements are assessed:

- Based on a forecast of future business performance given expectations of economic and market conditions over the forecast period.
- Based on a forecast of future business performance under adverse economic and market conditions over the forecast period. A range of scenarios of different severity may be examined.

The examination of capital requirements under normal economic and market conditions enables RBS to demonstrate how its projected business performance allows it to meet all internal and regulatory capital requirements as they arise over the plan horizon. For example, RBS will assess its ability to issue loss-absorbing debt instruments in sufficient quantity to meet regulatory timelines. The cost of issuance will be factored into business performance metrics.

The examination of capital requirements under adverse economic and market conditions is assessed through stress testing.

The results of stress tests are not only used widely across RBS but also by the regulators to set specific capital buffers. RBS takes part in a number of stress tests run by regulatory authorities to test industry-wide vulnerabilities under crystallising global and domestic systemic risks. In 2017, RBS took part in the Bank of England stress test. Details of the stress test are set out on page 162.

Internal assessment of capital adequacy

An internal assessment of material risks is carried out annually to enable an evaluation of the amount, type and distribution of capital required to cover these risks. This is referred to as the Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP consists of a point-in-time assessment of RBS's exposures and risks at the end of the financial year together with a forward-looking stress capital assessment. The ICAAP is approved by the Board and submitted to the PRA.

The ICAAP is used to form a view of capital adequacy separately to the minimum regulatory requirements. The ICAAP is used by the PRA to make an assessment of RBS-specific capital requirements through the Pillar 2 framework.

Capital allocation

RBS has mechanisms to allocate capital across its legal entities and businesses which aim to optimise the utilisation of capital resources taking into account applicable regulatory requirements, strategic and business objectives and risk appetite.

The framework for allocating capital is approved by the Asset & Liability Management Committee.

Governance

Capital management is subject to substantial review and governance. Formal approval of capital management policies is either by the Asset & Liability Management Committee or by the Board on the recommendation of the Board Risk Committee.

The Board approves the capital plans, including those for key legal entities and businesses as well as the results of the stress tests relating to those capital plans.

Stress testing: liquidity

Liquidity risk monitoring and contingency planning

In implementing the liquidity risk management framework, a suite of tools is used to monitor, limit and stress test the risks on the balance sheet. Limit frameworks are in place to control the level of liquidity risk, asset and liability mismatches and funding concentrations.

Liquidity risks are reviewed at significant legal entity and business levels daily, with performance reported to the Asset & Liability Management Committee at least monthly. Liquidity Condition Indicators are monitored daily which ensures any build-up of stress is detected early and the response escalated appropriately through recovery planning.

Internal assessment of liquidity

Under the liquidity risk management framework, RBS maintains the Individual Liquidity Adequacy Assessment Process (ILAAP). This includes assessment of net stressed liquidity outflows. RBS considers a range of extreme but plausible stress scenarios on its liquidity position over various time horizons, as outlined below.

Type	Description
Idiosyncratic scenario	The market perceives RBS to be suffering from a severe stress event, which results in an immediate assumption of increased credit risk or concerns over solvency.
Market-wide scenario	A market stress event affecting all participants in a market through contagion, counterparty failure and other market risks. RBS is affected under this scenario but no more severely than any other participants with equivalent exposure.
Combined scenario	This scenario models the combined impact of an idiosyncratic and market stress occurring at once. The combined scenario reflects the contingency that a severe name-specific event occurs at RBS in conjunction with a broader market stress, causing wider damage to the market and financial sector and severely affecting funding markets and assets.

RBS uses the most severe combination of these to set the internal stress testing scenario. The results of this enable RBS to set its internal liquidity risk appetite, which complements the regulatory liquidity coverage ratio requirement.

Business review **Capital and risk management**

Risk management framework (unaudited) *continued*

Stress testing: recovery and resolution planning

The RBS Group maintains a recovery plan that sets out credible recovery options that could be implemented in the event of a severe stress to restore its business to a stable and sustainable condition, focusing on addressing the capital and liquidity position of the RBS Group and its constituent legal entities.

The recovery plan sets out a range of triggers that activate the implementation of the recovery plan and sets out the operational plan for implementation of appropriate recovery options.

The recovery plan is a key component of risk management including the framework for managing capital.

The recovery plan is prepared and updated annually and approved by the Board. Following Board approval it is also submitted to the PRA each year. The recovery plan is assessed for appropriateness on an ongoing basis, and is maintained in line with regulatory requirements.

Two significant legal entities, RBS Securities Inc. and The Royal Bank of Scotland International Limited, maintained separate recovery plans to address specific risks. These plans were aligned to the 2017 RBS recovery plan to ensure they operated consistently in the event of a stress scenario.

Resolution would be implemented if the RBS Group was assessed by the UK authorities to have failed and the appropriate regulator placed the RBS Group into resolution. The process of resolution is owned and implemented by the Bank of England (as UK Resolution Authority).

The RBS Group is working with UK and global regulators to ensure that it is compliant with the principles of resolution planning. This includes, but is not limited to, establishing appropriate loss-absorbing capacity and ability to maintain operational continuity in resolution, across all of RBS Group's main legal entities, including NatWest Bank Plc. Reflecting the degree of change required to ensure RBS Group is resolvable, a multi-year programme is in place to develop resolution capability and meet regulatory requirements.

Stress testing: market risk

Non-traded market risk

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Non-traded exposures are reported to the PRA on a quarterly basis as part of the Stress Testing Data Framework. The return provides the regulator with an overview of RBS's banking book interest rate exposure, providing detailed product information analysed by interest rate driver and other characteristics including accounting classification, currency and, counterparty type.

Scenario analysis based on hypothetical adverse scenarios is performed on non-traded exposures as part of the industry-wide Bank of England and European Banking Authority stress exercises. In addition, RBS produces its own internal scenario analysis as part of the financial planning cycles.

Non-traded market risk exposures are capitalised through the ICAAP. The process covers the following risk types: gap risk, basis risk, credit spread risk, pipeline risk, structural foreign exchange risk, prepayment risk and accounting volatility risk. The ICAAP is completed with a combination of value and earnings measures. The total non-traded market risk capital requirement is determined by adding the different charges for each sub risk type. The ICAAP methodology captures at least ten years of historical volatility, produced with 99% confidence level. Methodologies are reviewed by RBS Model Risk and the results are approved by the Capital Management & Stress Testing Committee.

Traded market risk

RBS undertakes daily market risk stress testing to identify vulnerabilities and potential losses in excess of, or not captured in, value-at-risk. The calculated stresses measure the impact of changes in risk factors on the fair values of the trading and available-for-sale portfolios.

RBS conducts historical, macroeconomic and vulnerability-based stress testing. Historical stress testing is a measure that is used for internal management. Using the historical simulation framework employed for value-at-risk, the current portfolio is stressed using historical data since 1 January 2005. This methodology simulates the impact of the 99.9 percentile loss that would be incurred by historical risk factor movements over the period, assuming variable holding periods specific to the risk factors and the businesses.

Historical stress tests form part of the market risk limit framework and their results are reported daily to senior management. Macroeconomic stress tests are carried out periodically as part of the bank-wide, cross-risk capital planning process. The scenario narratives are translated into risk factor shocks using historical events and insights by economists, risk managers and the first line.

Market risk stress results are combined with those for other risks into the capital plan presented to the Board. The cross-risk capital planning process is conducted once a year, with a planning horizon of five years. The scenario narratives cover both regulatory scenarios and macroeconomic scenarios identified by RBS.

Vulnerability-based stress testing begins with the analysis of a portfolio and expresses its key vulnerabilities in terms of plausible, vulnerability scenarios under which the portfolio would suffer material losses. These scenarios can be historical, macroeconomic or forward-looking/hypothetical. Vulnerability-based stress testing is used for internal management information and is not subject to limits. However, the results for relevant scenarios are reported to senior management.

Business review **Capital and risk management**

Risk management framework (unaudited) *continued*

Regulatory stress testing

In 2017, the Group participated in a regulatory stress test conducted by the Bank of England. The scenario is hypothetical in nature and does not represent a forecast of the Group's future business or profitability. The results of the regulatory stress tests are carefully assessed by the Group and form part of the wider risk management of the Group.

Bank of England stress test

- Designed to assess the resilience of major UK banks to tail risk events. The severity of the test is related to policymakers' assessments of risk levels across markets and regions.

Scenario

- The 2017 stress test examined the impact over five years of deep simultaneous recessions in the UK and global economies, large falls in asset prices and a separate stress of misconduct costs. The economic scenario in the test is more severe than the global financial crisis.

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- Under the 2017 Bank of England stress test, CET1 ratio reached a low point of 6.4%, below the hurdle rate of 6.7%.

- Post the impact of management actions and the conversion of AT1 capital, the Group's low point CET1 ratio increased from 6.4% to 7.0%, meeting the hurdle rate but remained below the Systemic Reference Point of 7.4%.

- Tier 1 leverage ratio was projected to be 3.7% under stress, above the 3.25% leverage hurdle rate. Post the impact of management actions and conversion of AT1 capital, the Tier 1 leverage ratio would have been 4.0%.

Results

- The stress was based on an end of 2016 balance sheet starting position. Since then, RBS has taken a number of actions to improve its capital position stress resilience, including the on-going run-down of Capital Resolution RWAs, the continued reduction in certain credit portfolios and the resolution of various litigation cases and regulatory investigations.

- In light of the steps that RBS has already taken to strengthen its capital position during 2017, the regulator did not require RBS to submit a revised capital plan.

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- The 2017 Bank of England stress test results demonstrate that good progress has been made in transforming the balance sheet to being safe and sustainable.

What does this mean?

- The reduction in the CET1 ratio from the start point to the minimum stressed ratio before the impact of strategic management actions or AT1 conversion has improved from 1,000 basis points last year to 700 basis points this year (pre-strategic management actions).

Business review **Capital and risk management**

Capital, liquidity and funding risk

Definitions (unaudited)

Capital consists of reserves and instruments issued that are available that have a degree of permanency and are capable of absorbing losses. A number of strict conditions set by regulators must be satisfied to be eligible to count as capital.

Capital adequacy risk is the risk that there is or will be insufficient capital and other loss absorbing debt instruments to operate effectively including meeting minimum regulatory requirements, operating within Board approved risk appetite and supporting its strategic goals.

Liquidity consists of assets that can be readily converted to cash within a short timeframe at a reliable value. Liquidity risk is the risk of being unable to meet financial obligations as and when they fall due.

Funding consists of on-balance sheet liabilities that are used to provide cash to finance assets. Funding risk is the risk of not maintaining a diversified, stable and cost-effective funding base.

Liquidity and funding risks arise in a number of ways, including through the maturity transformation role that banks perform. The risks are dependent on factors such as:

- Maturity profile;
- Composition of sources and uses of funding;
- The quality and size of the liquidity portfolio;
- Wholesale market conditions; and
- Depositor and investor behaviour.

Sources (unaudited)

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Capital

The determination of what instruments and financial resources are eligible to be counted as capital is laid down by applicable regulation. Capital is categorised under two tiers (Tier 1 and Tier 2) according to the ability to absorb losses, degree of permanency and the ranking of absorbing losses on either a going or gone concern basis. There are three broad categories of capital across these two tiers:

- **CET1 capital.** CET1 capital must be perpetual and capable of unrestricted and immediate use to cover risks or losses as soon as these occur. This includes ordinary shares issued and retained earnings.
- **AT1 capital.** This is the second type of loss absorbing capital and must be capable of absorbing losses on a going concern basis. These instruments are either written down or converted into CET1 capital when a pre-specified CET1 ratio is reached.
- **Tier 2 capital.** Tier 2 capital is the Group's supplementary capital and provides loss absorption on a gone concern basis. Tier 2 capital absorbs losses after Tier 1 capital. It typically consists of subordinated debt securities with a minimum maturity of five years.

Minimum requirement for own funds and eligible liabilities (MREL)

In addition to capital, other specific loss absorbing instruments including senior notes issued by the Group may be used to cover certain gone concern capital requirements which, in the EU, is referred to as MREL. Gone concern refers to the situation in which resources must be available to enable an orderly resolution, in the event that the Bank of England (BoE) deems that the Group has failed.

Liquidity

RBS maintains a prudent approach to the definition of liquidity resources. Liquidity resources are divided into primary and secondary liquidity as follows:

- Primary liquid assets include cash and balances at central banks, treasury bills and other high quality government and US agency bonds.
- Secondary liquid assets are eligible as collateral for local central bank liquidity facilities. These assets include own-issued securitisations or whole loans that are retained on balance sheet and pre-positioned with a central bank so that they may be converted into additional sources of liquidity at very short notice.

Funding

RBS's primary funding sources are as follows:

Type	Description
Customer deposits	Licensed deposit-taking entities operating as PBB, CPB and RBSI franchises.
Wholesale markets	Short-term (less than 1 year) unsecured money markets and secured repo market funding.
Term debt	Issuance of long-term (more than 1 year) unsecured and secured debt securities.
Central bank funding facilities	The use of such facilities can be both part of a wider strategic objective to support initiatives to help stimulate economic growth or as part of the broader liquidity management and funding strategy.

For further details on capital constituents and the regulatory framework covering capital, liquidity and funding requirements, please refer to the RBS Pillar 3 Report 2017 on pages 4 and 8. For MREL refer to page 163.

Key developments in 2017 (unaudited)

- RBS continued to strengthen and de-risk its capital position; CET1 ratio remains ahead of the 13% target and increased by 250 basis points in the year end to 15.9% (40 basis points in Q4 2017), despite absorbing significant litigation and conduct costs, restructuring costs and disposal losses. IFRS 9 adoption on 1 January 2018 favourably impacts CET1 by 30 basis points. RWAs reduced by £27.3 billion to £200.9 billion reflecting the rundown of NatWest Markets legacy assets and reductions across other businesses. In addition, RBS was not required to submit a revised capital plan following the 2017 Bank of England (BOE) stress testing exercise.

Business review **Capital and risk management**

Capital, liquidity and funding risk *continued*

- CRR leverage ratio increased to 5.3% (2016 5.1%). UK leverage ratio improved to 6.1% (2016 5.6%) reflecting higher central bank balances which are excluded from the UK framework.
- During the year the BOE published indicative data on the minimum amount of loss-absorbing resources for the larger UK banks comprising MREL plus buffers. RBS is expected to require loss-absorbing resources of 24.0% of RWAs by 1 January 2020, rising to 27.8% by 1 January 2022. Total loss absorbing capital, based on RBS's interpretation of the rules and including the benefit of legacy securities, was 27.1% of RWAs at 31 December 2017.
- The liquidity portfolio increased by £22 billion in 2017 to £186 billion, mainly within primary liquidity which is now £124 billion (2016 £95 billion). This build up in liquidity is driven by TFS participation, increased deposits in the franchises and Treasury issuance, offset by funding maturities and calls of securities.
- The rise in primary liquidity resulted in higher liquidity coverage ratio (LCR) and stressed outflow coverage (SOC) of 152% (2016 123%) and 168% (2016 139%) respectively. The increase in LCR reflected preparations for the settlement of litigation, the rise in the minimum regulatory requirement from 90% to 100% on 1 January 2018 and preparations for ring-fencing.
- The net stable funding ratio rose to 132% (2016 121%), above the minimum target of 100%. The increase in NSFR was primarily driven by increased available stable funding.
- The regulatory agenda continues to rapidly evolve in the UK, Europe and internationally. RBS manages its capital, liquidity and funding to meet both current and future regulatory requirements whilst ensuring that we continue to serve customers well.

Capital management *(unaudited)*

Capital management ensures that there is sufficient capital and other loss absorbing instruments to operate effectively including meeting minimum regulatory requirements, operating within Board approved risk appetite, maintaining its credit rating and supporting its strategic goals.

Capital management is critical in supporting the businesses and is enacted through an end to end framework across businesses and the legal entities.

Capital planning is integrated into the Group's wider annual budgeting process and is assessed and updated at least monthly. Regular returns are submitted to the PRA which include a two year rolling forward view. Other elements of capital management, including risk appetite and stress testing, are set out on pages 156 and 159.

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Produce capital plans

- Capital plans are produced for the Group, its key operating entities and its businesses over a five year planning horizon under expected and stress conditions. Stressed capital plans are produced to support internal stress testing through the ICAAP or for regulatory purposes.

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- Shorter term forecasts are developed frequently in response to actual performance, changes in internal and external business environment and to manage risks and opportunities.

Assess

- Capital plans are developed to maintain capital of sufficient quantity and quality to support the Group's business and strategic plans over the planning horizon within approved risk appetite, as determined via stress testing, and minimum regulatory requirements.

capital

adequacy

- Capital resources and capital requirements are assessed across a defined planning horizon.
- Impact assessment captures input from across the Group including from businesses.

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- Capital planning informs potential capital actions including managing capital through buy backs, redemptions or through new issuance to external investors or via internal transactions.

Inform

capital

- Decisions on capital actions will be influenced by strategic and regulatory requirements, the cost and prevailing market conditions.

actions

- As part of capital planning, the Group will monitor its portfolio of external capital securities and assess the optimal blend and most cost effective means of financing.

Capital planning is one of the tools that the Group uses to monitor and manage capital risk on a going and gone concern basis, including the risk of excessive leverage.

Liquidity and funding management follows a similar process to that outlined above for capital.

Liquidity portfolio management (unaudited)

The size of the portfolio is determined by referencing RBS's liquidity risk appetite. RBS retains a prudent approach to setting the composition of the liquidity portfolio, which is subject to internal policies and limits over quality of counterparty, maturity mix and currency mix.

Business review **Capital and risk management**

Capital, liquidity and funding risk *continued*

RBS categorises its liquidity portfolio, including its locally managed liquidity portfolios, into primary and secondary liquid assets. The majority of the portfolio is centrally managed by RBS Treasury, for which the RBS Treasurer is responsible. This portfolio is held in the PRA regulated UK Domestic Liquidity Subgroup (UK DoLSub) comprising RBS's five licensed deposit taking UK banks: The Royal Bank of Scotland plc, National Westminster Bank Plc, Ulster Bank Limited, Coutts & Co and Adam & Company PLC.

Two of RBS's significant operating subsidiaries, RBS N.V. and Ulster Bank Ireland DAC, hold locally managed portfolios that comply with local regulations that may differ from PRA rules.

The liquidity value of the portfolio is determined by taking current market prices and applying a discount or haircut, to give a liquidity value that represents the amount of cash that can be generated by the asset.

Separate from the liquidity portfolio, RBS holds high quality assets to meet payment systems collateral requirements; these are managed by RBS Treasury.

Ring-fencing implications

As a result of the legal entity restructuring in response to the UK government's ring-fencing legislation, the current Royal Bank of Scotland plc (expected to be renamed NatWest Markets plc at the time of the RFTS during the first half of 2018) will separately hold and manage its own liquidity portfolio outside of the ring-fenced group. It will cease to form part of the UK DoLSub at a point in time in the second half of 2018 (subject to regulatory agreement). RBS International will begin to hold its own liquidity portfolio and RBS N.V. and UBI DAC will continue to hold separate liquidity to meet local regulatory requirements.

Treasury has commenced the transfer of the existing liquidity portfolio from RBS plc into National Westminster Bank Plc (where the majority of the UK DoLSub liquidity portfolio will be held post ring-fencing) to ensure appropriate levels of liquidity are held in both RBS plc and the UK DoLSub.

The size of the liquidity portfolio to be held by the future NatWest Markets plc should not be considered comparable to that held by the current RBS plc.

For further information, please refer to RBS Group ring-fencing on page 108.

Funding risk management (unaudited)

RBS manages funding risk through a comprehensive framework which measures and monitors the funding risk on the balance sheet.

The asset and liability types broadly match. Customer deposits provide more funding than customer loans utilise; repurchase agreements are largely covered by reverse repurchase agreements; interbank lending and funding largely nets off and derivative assets are broadly netted against derivative liabilities.

Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Minimum requirements (unaudited)

Capital adequacy ratios

The Group is subject to minimum requirements in relation to the amount of capital it must hold in relation to its RWAs. The table below summarises the minimum ratios of capital to RWAs that the Group is expected to have to meet once CRR is fully implemented by 1 January 2019. These ratios apply at the consolidated group level. Different minimum capital requirements may apply to individual legal entities or sub-groups.

Minimum requirements	Type	CET1	Total Tier 1	Total capital
System wide	Pillar 1 minimum requirements	4.5%	6.0%	8.0%
	Capital conservation buffer	2.5%	2.5%	2.5%
	UK countercyclical capital buffer (1)	1.0%	1.0%	1.0%
	G-SIB buffer (2)	1.0%	1.0%	1.0%
	Pillar 2A(4)	2.1%	2.9%	3.8%
Bank specific				
Total (excluding PRA buffer)(5)		11.1%	13.4%	16.3%

Notes:

(1) The countercyclical capital buffer (CCyB) applied to UK designated assets is set by the Financial Policy Committee (FPC). The UK CCyB may be set between 0% and 2.5% and is linked to the state of the UK economy. The Bank of England's Financial Policy Committee (FPC) increased the UK CCyB from 0.0% to 0.5%, with effect from June 2018; subsequently in November 2017 the FPC announced a further increase to 1.0% effective November 2018. The estimated own funds impact for the Group, based on the CCyB rate of 1.0% and 31 December 2017 exposures, was £1,343 million. Foreign exposures may be subject to different CCyBs depending on the CCyB rate set in the jurisdiction of the foreign exposure.

(2) Globally systemically important banks (G-SIBs), as designated by the Financial Stability Board (FSB), are subject to an additional capital buffer of between 1% and 3.5%. Based on the most recent determination of the FSB, the Group is subject to an additional capital requirement of 1.0%

(3) The Group will be subject to a systemic risk buffer (SRB) of between 0% and 3%. The SRB will apply from 1 January 2019 and will apply at the ring-fenced bank sub-group level rather than at the consolidated group level. The SRB may require the Group to hold a minimum amount of capital at the consolidated group level beyond the levels set out in the table above.

(4) From 1 January 2015, RBS has been required to meet at least 56% of its Pillar 2A capital requirement with CET1 capital and with balance with Additional Tier 1 and/or Tier 2 capital. Additional capital requirements under Pillar 2A may be specified by the PRA as a ratio or as an absolute value. The table sets out an implied ratio to cover the full value of Pillar 2A requirements. The PRA has recently determined that the Pillar 2A capital requirement for 2018 remains unchanged.

(5) The Group may be subject to a PRA buffer requirement as set by the PRA. The PRA buffer consists of two components:

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- A risk management and governance buffer that is set as a scalar of the Pillar 1 and Pillar 2A requirements. The scalar could range between 10% and 40%.

- A buffer relating to the results of the BoE concurrent stress testing results.

The PRA requires that the level of this buffer is not publicly disclosed.

(6) The capital conservation buffer, the countercyclical capital buffer, the G-SIB buffer and systemic risk buffer (where applicable) make up the combined buffer. If the Group fails to meet the combined buffer requirement, it is subject to restrictions on distributions on CET1 instruments, discretionary coupons on AT1 instruments and on payment of variable remuneration or discretionary pension benefits. These restrictions are calculated by reference to the Group's Maximum Distributable Amount (MDA). The MDA trigger is below the PRA buffer and MDA restrictions are not automatically triggered if the Group fails to meet its PRA buffer. The MDA is calculated as the amount of interim or year-end profits not yet incorporated into CET1 capital multiplied by a factor ranging from 0 to 0.6 depending on the size of the CET1 shortfall against the combined buffer.

Leverage ratios

The table below summarises the minimum ratios of capital to leverage exposure under the PRA UK leverage framework that the Group must meet. In November 2016, the European Commission published a package of legislative proposals (CRR 2) for the adoption of a legally binding 3% of Tier 1 capital minimum leverage ratio with consideration of a leverage buffer ratio for G-SIBs once a final international agreement had been reached. Different minimum requirements may apply to individual legal entities or sub-groups.

Type	CET1	Total Tier 1
Minimum ratio	2.4375%	3.25%
UK countercyclical leverage ratio buffer	0.00%	0.00%
Additional leverage ratio buffer	0.35%	0.35%
Total	2.7875%	3.60%

Notes:

(1) The countercyclical leverage ratio buffer is set at 35% of the Group's CCyB. As noted above this buffer may be set between 0% and 2.5% and the Financial Policy Committee (FPC) increased the rate from 0.0% to 0.5% effective June 2018; subsequently in November 2017 the FPC announced a further increase to 1% effective November 2018. The applicable ratio for foreign exposures may be different. On 3 October 2017 the PRA, via revised policy statement (PS21/17), increased the Tier 1 leverage ratio requirement for UK banks by 25 basis points to 3.25% (CET1 requirement of 2.4375%). The PRA minimum leverage ratio requirement is supplemented with a G-SIB additional leverage ratio buffer, currently 0.175% under transitional arrangements (31 December 2016 0.13125%) increasing to 0.35% at the end point, and countercyclical capital buffer of 0.0%.

Liquidity and funding ratios

The table below summarises the minimum requirements for key liquidity and funding metrics, under the relevant legislative framework.

Type	From 1 January 2017	From 1 January 2018
Liquidity coverage ratio (LCR) (1)	90%	100%
Net stable funding ratio (NSFR) (2)	N/A	100%

Notes:

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(1) On 1 October 2015 the LCR became the PRA's primary regulatory liquidity standard. It is a Pillar 1 metric to which the PRA apply Pillar 2 add-ons. The minimum ratio above excludes Pillar 2 add-ons.

(2) BCBS issued its final recommendations for the implementation of the net stable funding ratio in October 2014, proposing an implementation date of 1 January 2018 by which time banks are expected to meet and maintain a ratio of 100%. In November 2016, the European Commission (EC) included a net stable funding ratio of 100% as part of the CRR 2 package of legislative proposals. The timing of a binding NSFR coming into force in the European Union and United Kingdom remains subject to uncertainty. In the meantime, RBS uses the definitions from the BCBS guidelines, and its own interpretations, to calculate the NSFR. RBS's ratio may not be comparable with those of other financial institutions.

Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Measurement

Capital and leverage: Key metrics (unaudited)

Capital, RWAs and capital adequacy ratios, on the basis of end-point Capital Requirements Regulation (CRR) and transitional rules, calculated in accordance with PRA definitions, are set out below.

	2017		2016	
	End-point	PRA transitional	End-point	PRA transitional
	CRR basis (1)	basis	CRR basis (1)	basis
	£bn	£bn	£bn	£bn
Capital				
CET1	32.0	32.0	30.6	30.6
Tier1	36.0	39.6	34.7	40.4
Total	42.8	47.9	43.8	52.3
RWAs				
Credit risk				
- non-counterparty	144.7	144.7	162.2	162.2
- counterparty	15.4	15.4	22.9	22.9
Market risk	17.0	17.0	17.4	17.4
Operational risk	23.8	23.8	25.7	25.7
Total RWAs	200.9	200.9	228.2	228.2
Capital adequacy ratios	%	%	%	%
CET1	15.9	15.9	13.4	13.4
Tier 1	17.9	19.7	15.2	17.7
Total	21.3	23.9	19.2	22.9
Leverage ratios	2017		2016	
Tier 1 capital (£bn)	36.0	39.6	34.7	40.4
CRR leverage exposure (£bn)	679.1	679.1	683.3	683.3
CRR leverage ratio (%)	5.3%	5.8%	5.1%	5.9%
Average Tier 1 capital (£bn) (2)	36.4	40.0	38.0	43.7
Average leverage exposure (£bn) (2)	692.5	692.5	712.1	712.1
Average leverage ratio (%) (2)	5.3%	5.8%	5.3%	6.1%
UK leverage ratio	6.1%	6.7%	5.6%	6.6%

Notes:

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(1) CRR as implemented by the Prudential Regulation Authority in the UK, with effect from 1 January 2014. All regulatory adjustments and deductions to CET1 have been applied in full for both bases with the exception of unrealised gains on available-for-sale securities which has been included from 2015 under the PRA transitional basis.

(2) Based on 3 month average of month end leverage exposure and Tier 1 Capital.

Measures in relation to end-point CRR basis, including RWAs, are based on the current interpretation, expectations, and understanding, of the CRR requirements, as well as further regulatory clarity and implementation guidance from the UK and EU authorities (end-point CRR basis).

Capital base:

Own funds are based on shareholders' equity. The adjustment arising from the application of the prudent valuation requirements to all assets measured at fair value, has been included in full. Additional valuation adjustments relating to unearned credit spreads on exposures under the advanced internal ratings approach has been included in the determination of the expected loss amount deducted from CET1. Where the deductions from AT1 capital exceed AT1 capital, the excess is deducted from CET1 capital. Based on our current interpretations of the Commission Delegated Regulation issued in December 2013 on credit risk adjustments, RBS's standardised latent provision has been reclassified to specific provision and is not included in Tier 2 capital.

RWAs:

Current securitisation positions are shown as risk-weighted at 1,250%. RWA uplifts include the impact of credit valuation adjustments and asset valuation correlation on large financial sector entities. RWAs reflect implementation of the full internal model method suite, and include methodology changes that took effect immediately on CRR implementation. Counterparties which meet the eligibility criteria under CRR are exempt from the credit valuation adjustments volatility charges.

Liquidity key metrics (unaudited)

The table below sets out the key liquidity and related metrics monitored by RBS.

	2017	2016
Liquidity portfolio	£186bn	£164bn
Liquidity coverage ratio (1)	152%	123%
Stressed outflow coverage (2)	168%	139%
Net stable funding ratio (3)	132%	121%
Loan:deposit ratio	88%	91%

Notes:

(1) On 1 October 2015 the LCR became the PRA's primary regulatory liquidity standard. It is a Pillar 1 metric to which the PRA apply Pillar 2 add-ons. The published LCR excludes Pillar 2 add-ons. RBS calculates the LCR using its own interpretations of the EU LCR Delegated Act, which may change over time and may not be fully comparable with those of other financial institutions.

(2) RBS's stressed outflow coverage (SOC) is measured by reference to the liquidity portfolio as a percentage of stressed contractual and behavioural outflows over three months under the worst of three severe stress scenarios of a market-wide stress, an idiosyncratic stress and a combination of both in RBS's ILAAP. This assessment is performed in accordance with PRA guidance.

(3) BCBS issued its final recommendations for the implementation of the net stable funding ratio in October 2014, proposing an implementation date of 1 January 2018 by which time banks are expected to meet and maintain a ratio of 100%. In November 2016, the European Commission (EC) included a net stable funding ratio of 100% as part of the CRR 2 package of legislative proposals. The timing of a binding NSFR coming into force in the European Union and United Kingdom remains subject to uncertainty. In the meantime, RBS uses the definitions from the BCBS guidelines, and its own interpretations, to calculate the NSFR. RBS's ratio may not be comparable with those of other financial institutions.

Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Capital and leverage: Capital resources

	2017	PRA	2016	PRA
	End-point	transitional	End-point	transitional
	CRR basis (1)	basis (1)	CRR basis (1)	basis (1)
	£m	£m	£m	£m
Shareholders equity (excluding non-controlling interests)				
Shareholders equity	48,330	48,330	48,609	48,609
Preference shares - equity	(2,565)	(2,565)	(2,565)	(2,565)
Other equity instruments	(4,058)	(4,058)	(4,582)	(4,582)
	41,707	41,707	41,462	41,462
Regulatory adjustments and deductions				
Own credit	(90)	(90)	(304)	(304)
Defined benefit pension fund adjustment	(287)	(287)	(208)	(208)
Cash flow hedging reserve	(227)	(227)	(1,030)	(1,030)
Deferred tax assets	(849)	(849)	(906)	(906)
Prudential valuation adjustments	(496)	(496)	(532)	(532)
Goodwill and other intangible assets	(6,543)	(6,543)	(6,480)	(6,480)
Expected losses less impairments	(1,286)	(1,286)	(1,371)	(1,371)
Other regulatory adjustments	28	28	(8)	(8)
	(9,750)	(9,750)	(10,839)	(10,839)
CET1 capital	31,957	31,957	30,623	30,623
Additional Tier 1 (AT1) capital				
Eligible AT1	4,041	4,041	4,041	4,041
Qualifying instruments and related share premium subject to phase out		3,416		5,416
Qualifying instruments issued by subsidiaries and held by third parties		140		339
AT1 capital	4,041	7,597	4,041	9,796
Tier 1 capital	35,998	39,554	34,664	40,419
Qualifying Tier 2 capital				
Qualifying instruments and related share premium	6,396	6,501	6,893	7,066
Qualifying instruments issued by subsidiaries and held by third parties	369	1,876	2,268	4,818

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Tier 2 capital	6,765	8,377	9,161	11,884
Total regulatory capital	42,763	47,931	43,825	52,303

Note:

(1) The Group's Tier 1 grandfathering cap is set at £4.8 billion for 2017 (2016 - £5.8 billion).

The table below analyses the movement in end-point CRR CET1, AT1 and Tier 2 capital for the year.

	CET1	AT1	Tier 2	Total
	£m	£m	£m	£m
At 1 January 2017	30,623	4,041	9,161	43,825
Profit for the year	752			752
Own credit	214			214
Share capital and reserve movements in respect of employee share schemes	139			139
Ordinary shares issued	300			300
Foreign exchange reserve	82			82
Available-for-sale reserves	17			17
Goodwill and intangibles deduction	(63)			(63)
Deferred tax assets	57			57
Prudential valuation adjustments	36			36
Expected loss over impairment provisions	85			85
Capital instruments issued				
Net dated subordinated debt/grandfathered instruments			(1,968)	(1,968)
Foreign exchange movements			(428)	(428)
Other movements	(285)			(285)
At 31 December 2017	31,957	4,041	6,765	42,763

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Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Leverage exposure (unaudited)

The leverage exposure is based on the CRR Delegated Act.

	End-point CRR basis 2017	2016
	£bn	£bn
Leverage		
Derivatives	160.8	247.0
Loans and advances	339.4	340.3
Reverse repos	40.7	41.8
Other assets	197.2	169.6
Total assets	738.1	798.7
Derivatives		
- netting	(161.7)	(241.7)
- potential future exposures	49.4	65.3
Securities financing transactions gross up	2.3	2.3
Undrawn commitments (analysis below)	53.1	58.6
Regulatory deductions and other adjustments	(2.1)	0.1
Leverage exposure	679.1	683.3

Note:

(1) The UK leverage ratio excludes central bank claims from the leverage exposure where deposits held are denominated in the same currency and of contractual maturity that is equal or longer than that of the central bank claims.

Weighted undrawn commitments (unaudited)

The table below provides a breakdown of weighted undrawn commitments.

2017	2016
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	£bn	£bn
Unconditionally cancellable credit cards	2.1	2.4
Other Unconditionally cancellable items	4.7	7.7
Unconditionally cancellable items (1)	6.8	10.1
Undrawn commitments <1 year which may not be cancelled	1.8	1.8
Other off-balance sheet items with 20% credit conversion factor (CCF)	0.6	0.9
Items with a 20% CCF	2.4	2.7
Revolving credit risk facilities	27.0	27.2
Term loans	3.6	3.1
Mortgages		0.1
Other undrawn commitments >1 year which may not be cancelled & off-balance sheet	2.1	3.3
Items with a 50% CCF	32.7	33.7
Items with a 100% CCF	11.2	12.1
Total	53.1	58.6

Note:

(1) Based on a 10% CCF.

Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Loss absorbing capital (unaudited)

The following table illustrates the components of estimated loss absorbing capital (LAC) in RBSG plc and operating subsidiaries and includes external issuances only. The table is prepared on a transitional basis, including the benefit of regulatory capital instruments issued from operating companies, to the extent they meet MREL criteria. For further details regarding regulatory requirements in relation to MREL, refer to page 163.

The roll-off profile relating to senior debt and subordinated debt instruments is set out on the next page.

	2017				2016			
	Par value (1) £bn	Balance sheet value £bn	Regulatory value (2) £bn	LAC value (3) £bn	Par value (1) £bn	Balance sheet value £bn	Regulatory value (2) £bn	LAC value (3) £bn
CET1 capital (4)	32.0	32.0	32.0	32.0	30.6	30.6	30.6	30.6
Tier 1 capital: end-point CRR compliant AT1 of which: RBSG (holdco)	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
of which: RBSG operating subsidiaries (opcos)	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Tier 1 capital: non end-point CRR compliant of which: holdco	3.5	3.6	3.5	2.6	5.5	5.6	5.5	4.0
of which: opcos	0.1	0.1	0.1	0.1	0.3	0.3	0.3	0.3
	3.6	3.7	3.6	2.7	5.8	5.9	5.8	4.3
Tier 2 capital: end-point CRR compliant of which: holdco	6.5	6.5	6.4	4.9	6.9	7.0	6.9	5.3
of which: opcos	2.3	2.4	0.5	0.5	6.0	6.4	4.0	5.6
	8.8	8.9	6.9	5.4	12.9	13.4	10.9	10.9
Tier 2 capital: non end-point CRR compliant of which: holdco	0.3	0.4	0.1	0.1	0.4	0.4	0.2	0.1
of which: opcos	2.1	2.3	1.5	2.0	2.5	2.7	2.1	2.1
	2.4	2.7	1.6	2.1	2.9	3.1	2.3	2.2
Senior unsecured debt securities issued by:								
RBSG holdco	9.3	9.2		8.3	6.9	6.8		5.0
RBS opcos	14.4	14.7			14.8	15.0		
	23.7	23.9		8.3	21.7	21.8		5.0
Total	74.5	75.2	48.1	54.5	77.9	78.8	53.6	57.0

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RWAs	200.9	228.2
Leverage exposure	679.1	683.3
LAC as a ratio of RWAs	27.1%	24.9%
LAC as a ratio of leverage exposure	8.0%	8.3%

Notes:

- (1) Par value reflects the nominal value of securities issued.
- (2) Regulatory capital instruments issued from operating companies are included in the transitional LAC calculation, to the extent they meet the MREL criteria.
- (3) LAC value reflects RBS's interpretation of the Bank of England's policy statement on the minimum requirements for own funds and eligible liabilities (MREL), published in November 2016. MREL policy and requirements remain subject to further potential development, as such RBS estimated position remains subject to potential change. Liabilities excluded from LAC include instruments with less than one year remaining to maturity, structured debt, operating company senior debt, and other instruments that do not meet the MREL criteria. Includes Tier 1 and Tier 2 securities prior to incentive to redeem.
- (4) Corresponding shareholders' equity was £48.3 billion (2016 - £48.6 billion).
- (5) Regulatory amounts reported for AT1, Tier 1 and Tier 2 instruments are before grandfathering restrictions imposed by CRR.

Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Roll-off profile (unaudited)

The following table illustrates the roll-off profile and weighted average spreads of RBS's major wholesale funding programmes.

Senior debt roll-off profile (1)	As at and		Roll-off profile					2023 & later
	for year ended 31 December		2019	2020	2021	2022		
RBSG	2017	H1 2018	H2 2018	2019	2020	2021	2022	
- amount (£m)	9,208	59	25	1,289	3	7	7,825	
- weighted average rate spread (bps)	202	172	171	205	162	224	201	
RBS plc								
- amount (£m)	14,624	5,105	1,651	2,521	2,863	1,117	1,367	
- weighted average rate spread (bps)	116	188	244	84	24	202	201	
RBS N.V.								
- amount (£m)	24	22			2			
- weighted average rate spread (bps)	114	125			5			
Securitisation								
- amount (£m)	396						396	
- weighted average rate spread (bps)	1,080						1,080	
Covered bonds								
- amount (£m)	6,307	923			3,169		2,215	
- weighted average rate spread (bps)	125	137			99		157	
Total notes issued (£m)	30,559	6,109	1,676	3,810	6,037	1,124	11,803	
Weighted average spread	156	231	141	117	211	42	85	
Subordinated debt instruments roll-off profile (2)								
RBSG (£m)	6,850	92	265	915		1,625	3,953	
RBS plc (£m)	2,652	1,888	111	37	101	288	227	
NatWest Plc (£m)	1,143	694				449		
RBS N.V. (£m)	881	142		214	11		514	
UBI DAC (£m)	76						76	
Total (£m)	11,602	2,816	376	1,166	112	2,362	4,770	

Notes:

(1) Based on final contractual instrument maturity.

(2) Based on first call date of instrument, however this does not indicate RBS's strategy on capital and funding management. The table above does not include debt accounted Tier 1 instruments although those instruments form part of the total subordinated debt balance.

(3) The weighted average spread reflects the average net funding cost to RBS and is calculated on an indicative basis.

(4) The roll-off table is based on sterling-equivalent balance sheet values.

Risk-weighted assets (unaudited)

The table below analyses the movement in credit risk RWAs on the end-point CRR basis during the year, by key drivers.

	Credit risk RWAs				Total £bn
	Non-counterparty £bn	Counterparty £bn	Market	Operational	
At January 2017	162.2	22.9	17.4	25.7	228.2
Foreign exchange movement	(0.6)	(0.6)			(1.2)
Business movements	(10.2)	(7.0)	(0.6)	(1.9)	(19.7)
Risk parameter changes (1)	(2.4)	0.1			(2.3)
Methodology changes	(4.3)				(4.3)
Model updates			0.2		0.2
At 31 December 2017	144.7	15.4	17.0	23.8	200.9

Note:

(1) PD model changes relating to counterparty risks are included with risk parameter changes in line with EBA Pillar 3 Guidelines issued in December 2016.

Business review **Capital and risk management**

Capital, liquidity and funding risk *continued*

RWAs by segment (unaudited)

The chart below illustrates the concentration of risk-weighted assets by segment.

The table below analyses the movement in end-point CRR RWAs by segment during the year.

	UK PBB	Ulster Bank RoI	Commercial Banking	Private Banking	RBSI	NatWest Markets	Central items & other	Total
	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Total RWAs At January 1 2017*	42.3	18.1	78.5	8.6	9.5	69.7	1.5	228.2

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Foreign exchange movement		0.5	(0.4)			(1.3)		(1.2)
Business movements	0.6		(3.9)	0.5		(16.4)	(0.5)	(19.7)
Risk parameter changes (1)	0.1	(0.6)	(2.4)			0.6		(2.3)
Methodology changes					(4.4)	0.1		(4.3)
Model updates						0.2		0.2
At 31 December 2017	43.0	18.0	71.8	9.1	5.1	52.9	1.0	200.9
Credit risk								
- non-counterparty	33.7	16.9	65.4	8.1	4.4	16.1	0.1	144.7
- counterparty		0.1				15.3		15.4
Market risk		0.1				16.2	0.7	17.0
Operational risk	9.3	0.9	6.4	1.0	0.7	5.3	0.2	23.8
Total RWAs	43.0	18.0	71.8	9.1	5.1	52.9	1.0	200.9

* Re-presented to reflect segment reorganisation.

Note:

(1) Risk parameter changes relate to changes in credit quality metrics of customers and counterparties such as probability of default (PD) and loss given default (LGD) as well as IRB model changes relating to counterparty credit risk (in line with EBA Pillar 3 Guidelines).

Key points (unaudited)

- RWAs decreased by £27.3 billion during the year with reductions across all risk types but primarily in non-counterparty credit risk (£17.5 billion) driven by reduced asset size and limit reductions in both NatWest Markets and Commercial Banking.
- The decrease in NatWest Markets primarily reflects reductions in the legacy business as it moved towards closure and lower counterparty credit risk resulting from mitigation activities.
- There has been a reduction in net lending in Commercial Banking as a result of growth in targeted segments being more than offset by active management of the lending book.
- During the year RBSI received regulatory approval to adopt the advanced internal ratings based approach on the wholesale corporate book, which led to an RWA reduction of £4.4 billion.
- In both UK PBB and Private Banking there has been growth in mortgage lending which has increased RWAs.
- Risk metric improvements in Ulster Bank RoI have been offset by foreign currency movements.

Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Liquidity portfolio

The table below shows the liquidity portfolio by product, liquidity value and carrying value. Liquidity value is lower than carrying value as it is stated after discounts (or haircuts) applied to instruments by the Bank of England and other central banks.

	Liquidity value										
	2017			2016							
	31 December		Total	Average		31 December		Average			
UK	Other	UK		Total	UK	Other	UK	Total	UK	Total	
	DoLSub (1)	£m	£m	DoLSub (1)	£m	DoLSub (1)	£m	£m	DoLSub (1)	£m	£m
Cash and balances at central banks	91,377	2,280	93,657	76,386	79,425	66,598	2,542	69,140	56,772	59,489	
Central and local government bonds											
AAA rated governments	2,760	1,184	3,944	4,074	5,049	3,936	1,331	5,267	3,692	4,539	
AA- to AA+ rated governments and US agencies	24,084	2,149	26,233	20,849	22,717	19,348	1,244	20,592	18,757	21,106	
Below AA rated governments							237	237			
Local government											
	26,844	3,333	30,177	24,923	27,766	23,284	2,812	26,096	22,449	25,645	
Primary liquidity	118,221	5,613	123,834	101,309	107,191	89,882	5,354	95,236	79,221	85,134	
Secondary liquidity (2)	62,144	411	62,555	61,577	62,114	68,007	683	68,690	65,588	66,774	
Total liquidity value	180,365	6,024	186,389	162,886	169,305	157,889	6,037	163,926	144,809	151,908	
Total carrying value	203,733	6,159	209,892			184,136	6,209	190,345			

Notes:

(1) The PRA regulated UK DoLSub comprising RBS's five licensed deposit-taking UK banks: The Royal Bank of Scotland plc, National Westminster Bank Plc, Ulster Bank Limited, Coutts & Co and Adam & Company PLC. In addition, certain of RBS's significant operating subsidiaries, RBS N.V. and Ulster Bank Ireland DAC, hold managed portfolios that comply with local regulations that may differ from PRA rules.

(2) Comprises assets eligible for discounting at the Bank of England and other central banks.

The table below shows the liquidity value of the liquidity portfolio by currency.

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Total liquidity portfolio	GBP £m	USD £m	EUR £m	Other £m	Total £m
2017	138,985	11,491	34,442	1,471	186,389
2016	128,614	9,582	24,833	897	163,926

Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Funding sources

The table below shows the carrying values of the principal funding sources based on contractual maturity.

By product	2017			2016		
	Short-term less than 1 year £m	Long-term more than 1 year £m	Total £m	Short-term less than 1 year £m	Long-term more than 1 year £m	Total £m
Deposits by banks						
Derivative cash collateral	12,404		12,404	20,674		20,674
Other deposits (1)	7,480	19,595	27,075	6,130	6,513	12,643
	19,884	19,595	39,479	26,804	6,513	33,317
Debt securities in issue						
Commercial paper and certificates of deposit	4,637		4,637	3,205	3	3,208
Medium-term notes	2,316	16,902	19,218	3,388	15,233	18,621
Covered bonds	987	5,321	6,308	96	3,839	3,935
Securitisations		396	396		1,481	1,481
	7,940	22,619	30,559	6,689	20,556	27,245
Subordinated liabilities	2,383	10,339	12,722	1,062	18,357	19,419
Notes issued	10,323	32,958	43,281	7,751	38,913	46,664
Wholesale funding	30,207	52,553	82,760	34,555	45,426	79,981
Customer deposits						
Derivative cash collateral (2)	10,279		10,279	11,487		11,487
Financial institution deposits	52,284	1,091	53,375	52,292	668	52,960
Personal deposits	173,314	1,497	174,811	162,958	1,877	164,835
Corporate deposits	127,708	861	128,569	123,495	1,095	124,590
Total customer deposits	363,585	3,449	367,034	350,232	3,640	353,872
Total funding excluding repos	393,792	56,002	449,794	384,787	49,066	433,853
Total repos	38,421		38,421	32,335		32,335
Central and other banks	7,419		7,419	5,239		5,239
Other financial institutions	25,480		25,480	25,652		25,652
Other corporate	5,522		5,522	1,444		1,444
Total funding including repos	432,213	56,002	488,215	417,122	49,066	466,188

Notes:

(1) Includes £19.0 billion (2016 - £5.0 billion) relating to TFS participation and £1.8 billion (2016 - £1.3 billion) relating to RBS's participation in central bank financing operations under the European Central Bank's Targeted Long Term Refinancing Operations.

(2) Cash collateral includes £9,113 million (2016 - £10,002 million) from financial institutions.

Key points

- During 2017, RBS issued new debt securities of £12.2 billion including:
 - o £3.6 billion of MREL-eligible senior debt by RBSG plc, bring the total issuance in 2016 and 2017 to £7.8 billion;
 - o £2.4 billion of covered bonds by RBS plc, the first such issuance for RBS since 2012; and
 - o £1.1 billion of senior unsecured notes issued by RBS plc to support the future standalone operations of NatWest Markets plc.
 - o Other issuance of £5.1 billion, including MTNs, commercial paper and CDs, and securitisations.
- In 2017, subordinated debt securities of £5.7 billion and senior unsecured debt securities of £9.0 billion were redeemed or matured through the year.
- Total wholesale funding increased by £2.8 billion in the year to £82.8 billion, driven by increased TFS participation of £14.0 billion in 2017, as well as issuance activity, offset by calls and maturities of subordinated debt and debt securities in issue. Short-term wholesale funding, excluding derivative collateral of £12.4 billion (2016 - £20.7 billion), increased by £3.9 billion during 2017 to £17.8 billion driven largely by issuance activity and new bank deposits.
- Repos at 31 December 2017 increased by £6.1 billion to £38.4 billion driven largely by strong demand in the market for high quality securities.
- Total reverse repos at 31 December 2017 were £1.1 billion lower at £40.7 billion (2016 - £41.8 billion). Fair value of securities received as collateral for reverse repos was £40.7 billion (2016 - £41.8 billion), of which £30.6 billion (2016 - £30.5 billion) had been rehypothecated for RBS's own transactions, in line with normal market practice.

Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Loan:deposit ratios and funding surplus/(gap)

The table below shows loans and advances to customers, customer deposits, loan:deposit ratios (LDR) and funding surplus/(gap).

	2017			2016*				
	Loans and advances to customers (1) £m	Customer deposits (2) £m	LDR %	Funding surplus/(gap) (3) £m	Loans and advances to customers (1) £m	Customer deposits (2) £m	LDR %	Funding surplus/(gap) (3) £m
UK PBB	161,677	180,636	90	18,959	152,653	169,992	90	17,339
Ulster Bank Rol	19,492	17,541	111	(1,951)	18,930	16,109	117	(2,821)
Commercial Banking	97,020	97,958	99	938	100,069	97,886	102	(2,183)
Private Banking	13,482	26,923	50	13,441	12,157	26,560	46	14,403
RBSI	8,708	28,975	30	20,267	8,774	25,176	35	16,402
NatWest Markets	22,728	14,811	nm	(7,917)	30,184	17,883	nm	(12,301)
Central items & other	77	190	nm	113	256	266	nm	10
	323,184	367,034	88	43,850	323,023	353,872	91	30,849

* Re-presented to reflect the segmental reorganisation.

Notes:

- (1) Excludes reverse repo agreements and net of impairment provisions.
- (2) Excludes repo agreements.
- (3) Calculated as customer deposits less loans and advances to customers.
- (4) nm = not meaningful.

Key points

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- The loan:deposit ratio was 88%, down from 91% at the end of 2016 driven by deposit growth, primarily in UK PBB and RBS International.
- Underlying loan growth in UK PBB, with smaller increases in Ulster Bank RoI and Private Banking, was offset by active management of the lending book in Commercial Banking and reductions in NatWest Markets.

The table below shows RBS's principal funding sources.

By currency	2017					2016				
	GBP £m	USD £m	EUR £m	Other £m	Total £m	GBP £m	USD £m	EUR £m	Other £m	Total £m
Deposits by banks (1)	24,874	1,375	12,874	356	39,479	11,143	2,423	17,827	1,924	33,317
Debt securities in issue										
Certificates of deposit & commercial papers	894	79	3,664		4,637	1,401		1,807		3,208
Medium-term notes (MTNs)	1,234	7,185	9,996	803	19,218	1,457	6,549	9,512	1,103	18,621
Covered bonds	2,356		3,952		6,308	1,134		2,801		3,935
Securitisations	396				396	175	302	1,004		1,481
	4,880	7,264	17,612	803	30,559	4,167	6,851	15,124	1,103	27,245
Subordinated liabilities	872	7,930	3,912	8	12,722	962	12,367	5,176	914	19,419
Wholesale funding	30,626	16,569	34,398	1,167	82,760	16,272	21,641	38,127	3,941	79,981
% of wholesale funding	37%	20%	42%	1%	100%	20%	27%	48%	5%	100%
Customer deposits (1)	313,517	15,668	35,242	2,607	367,034	299,693	17,791	33,144	3,244	353,872
Total funding excluding repos	344,143	32,237	69,640	3,774	449,794	315,965	39,432	71,271	7,185	433,853
% of total funding	77%	7%	15%	1%	100%	73%	9%	16%	2%	100%

Note:

- (1) Excludes repo agreements.

Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Notes issued - residual maturity profile by note type

The table below shows RBS's debt securities in issue and subordinated liabilities by residual contractual maturity.

	Debt securities in issue						Total notes in issue £m	Total notes in issue %
	Commercial paper and CDs £m	MTNs £m	Covered bonds £m	Securitisations £m	Total £m	Subordinated liabilities £m		
2017								
Less than 1 year	4,637	2,316	987		7,940	2,383	10,328	24
1-3 years		6,581	3,146		9,727	208	10,052	23
3-5 years		4,639			4,639	2,329	6,931	16
More than 5 years		5,682	2,175	396	8,253	7,802	15,970	37
Total including disposal groups	4,637	19,218	6,308	396	30,559	12,722	43,281	100
2016								
Less than 1 year	3,205	3,388	96		6,689	1,062	7,751	17
1-3 years	3	4,937	871		5,811	2,814	8,625	18
3-5 years		3,323	1,883		5,206	483	5,689	12
More than 5 years		6,973	1,085	1,481	9,539	15,060	24,599	53
Total	3,208	18,621	3,935	1,481	27,245	19,419	46,664	100

Behavioural analysis (unaudited)

The contractual maturity of balance sheet assets and liabilities reflects the maturity transformation role banks perform, lending long-term but mainly obtaining funding through short-term liabilities such as customer deposits. In practice, the behavioural profiles of many liabilities show greater stability and longer maturity than the contractual maturity. This is particularly true of many types of retail and corporate deposits which, despite being repayable on demand or at short notice, have demonstrated very stable characteristics even in periods of acute stress.

In its analysis to assess and manage asset and liability maturity gaps, RBS determines the expected customer behaviour through qualitative and quantitative techniques. These incorporate observed customer behaviours over long periods of time. This analysis is subject to governance through RBS ALCo Technical committee down to a segment level.

The net behavioural funding surplus/(gap) and contractual maturity analysis is set out below.

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	Loans to customers				Contractual maturity Customer accounts				Net surplus/(gap)				Behavioural maturity Net surplus/(gap)			
	Less than	1-5	Greater than	Total	Less than	1-5	Greater than	Total	Less than	1-5	Greater than	Total	Less than	1-5	Greater than	Total
	1	years	5 years		1	years	5 years		1	years	5 years		1	years	5 years	
2017	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
UK PBB	16	38	108	162	179	2		181	163	(36)	(108)	19	(4)	3	20	19
UB RoI	1	6	12	19	16	1		17	15	(5)	(12)	(2)	1	(2)	(1)	(2)
CB	38	40	19	97	98			98	60	(40)	(19)	1	(8)	23	(14)	1
PB	5	5	3	13	27			27	22	(5)	(3)	14	1	2	11	14
RBSI	4	2	3	9	29			29	25	(2)	(3)	20	4	5	11	20
NWM	19	2	2	23	14	1		15	(5)	(1)	(2)	(8)		(7)	(1)	(8)
Total	83	93	147	323	363	4		367	280	(89)	(147)	44	(6)	24	26	44
2016																
Total	86	95	142	323	350	4		354	264	(91)	(142)	31	1	13	17	31

* Re-presented to reflect the segmental reorganisation.

Key points (unaudited)

- The net funding surplus has increased by £13 billion during 2017 to £44 billion, largely driven by deposit growth (mainly in UK PBB and RBSI International). NatWest Markets lending reduction exceeded deposit reduction, resulting in a lower funding gap in 2017.
- Customer deposits and customer loans are broadly matched from a behavioural perspective.
- The net funding surplus in 2017 is concentrated in the longer-dated buckets, reflecting the stable characteristics of customer deposits and lending that is behaviourally shorter dated.

Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Contractual maturity

This table shows the residual maturity of financial instruments, based on contractual date of maturity. Held-for-trading (HFT) assets and liabilities have been excluded from the maturity analysis due to their short-term nature and are shown in total in the table below. Hedging derivatives are included in the relevant maturity bands.

	Other than held-for-trading								Total		
	Less than 1 month £m	1-3 months £m	3-6 months £m	6 months - 1 year £m	Subtotal £m	1-3 years £m	3-5 years £m	More than 5 years £m	excluding HFT £m	HFT £m	Total £m
2017											
Cash and balances at central banks	98,337				98,337				98,337		98,337
Bank reverse repos	1,674	478			2,152				2,152	11,845	13,997
Customer reverse repos	1,133	902	273		2,308				2,308	24,427	26,735
Loans to banks	8,470	503	246	53	9,272	93			9,365	6,889	16,254
Loans to customers	32,495	7,999	8,570	18,461	67,525	52,616	41,256	146,467	307,864	15,320	323,184
Personal	4,375	2,458	3,346	6,162	16,341	21,242	18,134	120,084	175,801	39	175,840
Corporate	24,354	4,616	4,236	8,056	41,262	27,164	21,630	24,026	114,082	2,474	116,556
Financial institutions (excluding banks)	3,766	925	988	4,243	9,922	4,210	1,492	2,357	17,981	12,807	30,788
Debt securities	1,053	2,451	2,101	3,171	8,776	10,893	10,474	21,309	51,452	27,481	78,933
Equity shares								421	421	29	450
Settlement balances	2,517				2,517				2,517		2,517
Derivatives	281			832	1,113	1,337	334	183	2,967	157,876	160,843
Total financial assets	145,960	12,333	11,190	22,517	192,000	64,939	52,064	168,380	477,383	243,867	721,250

2016
Total financial assets 127,389 12,117 13,626 23,230 176,362 65,422 50,577 160,870 453,231 328,852 782,083

Bank repos	2,988	200	201		3,389				3,389	4,030	7,419
Customer repos	6,669				6,669				6,669	24,333	31,002
Deposits by banks	5,474	477	137	1,337	7,425	3,448	16,007	127	27,007	12,472	39,479
Customer accounts	338,997	7,196	3,288	3,413	352,894	2,520	67	40	355,521	11,513	367,034
Personal	166,758	2,771	1,407	2,378	173,314	1,497			174,811		174,811
Corporate	122,399	1,661	1,445	712	126,217	455		40	126,712	1,857	128,569
Financial institutions (excluding banks)	49,840	2,764	436	323	53,363	568	67		53,998	9,656	63,654

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Debt securities in issue	1,521	2,442	2,182	1,614	7,759	9,518	4,333	7,842	29,452	1,107	30,559
Settlement balances	2,844				2,844				2,844		2,844
Short positions										28,527	28,527
Derivatives		212	289		501	1,188	526	1,356	3,571	150,935	154,506
Subordinated liabilities	5	37	2,058	283	2,383	208	2,329	7,802	12,722		12,722
Other liabilities	2,186				2,186				2,186		2,186
Total financial liabilities	360,684	10,564	8,155	6,647	386,050	16,882	23,262	17,167	443,361	232,917	676,278

2016											
Total financial liabilities	341,986	7,851	6,386	6,575	362,798	13,859	11,042	25,760	413,459	316,954	730,413

Business review Capital and risk management

Capital, liquidity and funding risk *continued*

Encumbrance

RBS evaluates the extent to which assets can be financed in a secured form (encumbrance), but certain asset types lend themselves more readily to encumbrance. The typical characteristics that support encumbrance are an ability to pledge those assets to another counterparty or entity through operation of law without necessarily requiring prior notification, homogeneity, predictable and measurable cash flows, and a consistent and uniform underwriting and collection process. Retail assets including residential mortgages, credit card receivables and personal loans display many of these features.

RBS categorises its assets into three broad groups, those that are:

- Already encumbered and used to support funding currently in place through own-asset securitisations, covered bonds and securities repurchase agreements.
- Pre-positioned with central banks as part of funding schemes and those encumbered under such schemes.
- Not currently encumbered. In this category, RBS has in place an enablement programme which seeks to identify assets capable of being encumbered and to identify the actions to facilitate such encumbrance whilst not affecting customer relationships or servicing.

Balance sheet encumbrance

	Encumbered as a result of transactions with counterparties other than central banks				Pre-positioned & encumbered assets held at central banks (4) £bn	Unencumbered assets not pre-positioned with central banks				Total £bn	Total £bn
	Covered bonds & securitisations (1) £bn	Derivatives £bn	Repos & similar (2) £bn	Total (3) £bn		Readily available (5) £bn	Other available (6) £bn	Cannot be used (7) £bn	Total £bn		
2017											
Cash and balances at central banks			5.3	5.3		93.0				93.0	98.3
Loans and advances											
- banks	0.7	6.9	0.7	8.3		7.5	0.3	0.2	8.0	16.3	
- residential mortgages											
- UK	8.9			8.9	105.5	22.1	10.8		32.9	147.3	
- Irish	4.1			4.1	3.0	7.4		0.1	7.5	14.6	
- credit cards						3.9	0.3		4.2	4.2	
- personal loans						6.7	2.8		9.5	9.5	

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- other	14.7		14.7	4.6	4.4	100.9	23.0	128.3	147.6	
Reverse repos							40.7	40.7	40.7	
Debt securities	1.4	40.8	42.2		34.9	0.1	1.7	36.7	78.9	
Equity shares		0.1	0.1		0.1	0.2	0.1	0.4	0.5	
Settlement balances							2.5	2.5	2.5	
Derivatives							160.8	160.8	160.8	
Intangible assets							6.5	6.5	6.5	
PP&E						3.2	1.6	4.8	4.8	
Deferred tax							1.7	1.7	1.7	
Other assets							3.9	3.9	3.9	
Total assets	13.7	23.0	46.9	83.6	113.1	180.0	118.6	242.8	541.4	738.1
2016										
Total assets	18.8	26.5	40.2	85.5	105.5	153.4	123.4	330.9	607.7	798.7

Notes:

- (1) Covered bonds and securitisations include securitisations, conduits and covered bonds.
- (2) Repos and other secured deposits, cash, coin and nostro balance held with the Bank of England as collateral against deposits and notes in circulation are included here rather than within those positioned at the central bank as they are part of normal banking operations.
- (3) Total assets encumbered as a result of transactions with counterparties other than central banks are those that have been pledged to provide security and are therefore not available to secure funding or to meet other collateral needs.
- (4) Assets pre-positioned at the central banks include loans provided as security as part of funding schemes and those encumbered under such schemes.
- (5) Readily available for encumbrance: including assets that have been enabled for use with central banks but not pre-positioned; cash and high quality debt securities that form part of RBS's liquidity portfolio and unencumbered debt securities.
- (6) Other assets that are capable of being encumbered are those assets on the balance sheet that are available for funding and collateral purposes but are not readily realisable in their current form. These assets include loans that could be prepositioned with central banks but have not been subject to internal and external documentation review and diligence work.
- (7) Cannot be used includes:
 - (a) Derivatives, reverse repurchase agreements and trading related settlement balances.
 - (b) Non-financial assets such as intangibles, prepayments and deferred tax.
 - (c) Loans that cannot be pre-positioned with central banks based on criteria set by the central banks, including those relating to date of origination and level of documentation.
 - (d) Non-recourse invoice financing balances and certain shipping loans whose terms and structure prohibit their use as collateral.
- (8) In accordance with market practice, RBS employs securities recognised on the balance sheet, and securities received under reverse repo transactions as collateral for repos.

Business review **Capital and risk management**

Credit risk: management basis

The following disclosures in this section are audited:

- Forbearance.
- Impairment provisioning and write-offs.
- Portfolio overview by geographical area.
- LTV distribution for mortgage lending.
- Commercial real estate LTV distribution.

Definition

Credit risk is the risk of financial loss due to the failure of a customer or counterparty to meet its obligation to settle outstanding amounts.

Sources of credit risk (unaudited)

The principal sources of credit risk for RBS are lending, off-balance sheet products, derivatives and securities financing, and debt securities. RBS is also exposed to settlement risk through foreign exchange, trade finance and payments activities.

Credit risk management function (unaudited)

Risk governance

The credit risk management function is led by the Chief Credit Officer (CCO). The function's activities include:

- Approving credit limits for customers.
- Defining concentration risk and implementing the credit risk control framework.
- Oversight of the first line of defence to ensure that credit risk remains within the risk appetite set by the Board.

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- Developing and monitoring compliance with credit risk policies.
- Conducting RBS-wide assessments of provision adequacy.

The CCO has overall responsibility for the credit risk function and chairs the Wholesale Credit Risk Committee as well as the Retail Credit Risk Committee. These committees have authority for risk appetite (within the appetite set by the Board), strategy, frameworks and policy as well as oversight of RBS's credit profile. The RBS Provisions Committee has authority over provisions adequacy and approves proposals from business provisions committees in accordance with approval thresholds. The RBS Provisions Committee is chaired either by the CCO or the Head of Provisions & Restructuring Credit.

Controls

Credit policy standards are in place for both the Wholesale and Personal portfolios. They are expressed as a set of mandatory controls.

Risk appetite (unaudited)

RBS's approach to lending is governed by comprehensive credit risk appetite frameworks. The frameworks are closely monitored and actions are taken to adapt lending criteria as appropriate. Credit risk appetite aligns to the strategic risk appetite set by the Board, which includes capital adequacy, earnings volatility, funding and liquidity, and stakeholder confidence. The credit risk appetite frameworks have been designed to reflect factors (e.g. strategic and emerging risks) that influence the ability to operate within risk appetite. Tools such as stress testing and economic capital are used to measure credit risk volatility and develop links between the credit risk appetite frameworks and risk appetite limits. The frameworks are supported by a suite of policies and transaction acceptance standards that set out the risk parameters within which franchises must operate.

For Wholesale the four formal frameworks used, and their basis for classification, are detailed in the following table.

Framework	Size	Basis for classification	Other
Single name concentration	Net exposure or loss given default for a given probability of default		
Sector	Exposure (1)	Risk based on economic capital and other qualitative factors	
Country	Exposure (1)		
Product and asset class	Exposure net/gross dependent on type of risk and limit definition.	Risk based on heightened risk characteristics	

Note:

- (1) Potential exposure as defined on the following page.

The Personal credit risk framework sets limits that measure and control the quality of both existing and new business for each relevant franchise or business segment. The actual performance of each portfolio is tracked relative to these limits and management action is taken where necessary. The limits apply to a range of credit risk-related measures including expected loss at a portfolio level, expected loss in a given stress scenario, projected credit default rates and the LTV ratio of the Personal mortgage portfolios.

Risk identification and measurement (unaudited)

Credit stewardship

Risks are identified through relationship management and credit stewardship of portfolios or customers. Credit risk stewardship takes place throughout the customer relationship, beginning with the initial approval. It includes the application of credit assessment standards, credit risk mitigation and collateral, ensuring that credit documentation is complete and appropriate, carrying out regular portfolio or customer reviews and problem debt identification and management.

Risk measurement

RBS uses current exposure and potential exposure as its measures of credit risk exposure. Unless otherwise stated, current exposure and potential exposure are reported:

- Net of collateral cash and gold collateral for all product types as well as financial collateral for derivative and securities financing products.
- Net of provisions credit valuation adjustments for derivative and securities financing products; individual, collective and latent provisions across all other product types.

Exposures backed by guarantees are allocated to the guarantor rather than the direct obligor. This does not affect the current or potential exposure amount, but does affect allocations to obligors, sectors, country and product and asset classes.

Business review Capital and risk management

Credit risk: management basis continued

The following table summarises the differences between current exposure and potential exposure across product types:

Product	Current exposure	Potential exposure(1,2)
Lending	Drawn balances	Legally-committed limits
Derivatives and securities financing	Measured using the mark-to-market value after the effect of enforceable netting agreements and net of legally enforceable financial collateral.(3)	Measured using scaled credit limit utilisation, which takes into account mark-to-market movements, any collateral held and expected market movements over a specified horizon.(3)
Contingent obligations	Issued amount of the guarantee or letter of credit	Legally-committed amount
Leases		Net present value plus residual value
Banking book debt securities		Purchase value less subsequent amortisation
Trading book bonds Equity securities Settlement risk		Not reported as credit risk
Suretyships Intra-group credit exposures		

Notes:

- (1) Potential exposure includes all drawn exposure and all legally-committed undrawn exposure.
- (2) Potential exposure cannot be less than current exposure.
- (3) Current exposure and potential exposure for exchange-traded derivatives are defined as exposure at default.

Risk models (unaudited)

The output of credit risk models is used in the credit approval process as well as for ongoing assessment, monitoring and reporting to inform risk appetite decisions. These models are divided into different categories. Where the calculation method is on an individual counterparty or account level, the models used will be probability of default (PD), loss given default (LGD), or exposure at default (EAD). The economic capital model is used for credit risk appetite setting.

Asset quality

Credit grades are assigned at legal entity level for Wholesale customers.

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All credit grades map to both an internal asset quality scale, used for external financial reporting, and a master grading scale for Wholesale exposures, which is used for internal management reporting across portfolios. Accordingly, measures of risk exposure may be aggregated and reported at differing levels of detail depending on stakeholder or business requirements. Performing loans are defined as AQ1-AQ9 (where the PD is less than 100%) and non-performing loans as AQ10 (where the PD is 100%).

Risk mitigation (unaudited)

Risk mitigation techniques, as set out in the appropriate credit policies, are used in the management of credit portfolios across RBS. These techniques mitigate credit concentrations in relation to an individual customer, a borrower group or a collection of related borrowers. Where possible, customer credit balances are netted against obligations. Mitigation tools can include structuring a security interest in a physical or financial asset, the use of credit derivatives including credit default swaps, credit-linked debt instruments and securitisation structures, and the use of guarantees and similar instruments (for example, credit insurance) from related and third parties. To mitigate credit risk arising from Personal mortgage lending, collateral is taken in the form of residential property.

The key sectors where RBS provides asset-backed lending are commercial real estate, shipping and residential mortgages. Valuation methodologies are detailed below.

Commercial real estate valuations RBS has a panel of chartered surveying firms that cover the spectrum of geography and property sectors in which RBS takes collateral. Suitable valuers for particular assets are contracted through a single service agreement to ensure consistency of quality and advice. Valuations are commissioned when an asset is taken as security; a material increase in a facility is requested; or a default event is anticipated or has occurred. In the UK, an independent third-party market indexation is applied to update external valuations once they are more than a year old.

Shipping valuations Vessel valuations are obtained using several different independent sources. Valuations are usually undertaken on a desktop basis, assuming a willing buyer and willing seller. Most vessels are valued on a charter-free basis, but in certain circumstances the valuations take account of longer term committed charter income. Valuations are normally performed on a quarterly basis. From time to time, particularly for facilities showing increased signs of financial stress, a more formal valuation or specialist advice will be obtained.

Residential mortgages

RBS takes collateral in the form of residential property to mitigate the credit risk arising from mortgages. RBS values residential property during the loan underwriting process by either appraising properties individually or valuing them collectively using statistically valid models. RBS updates residential property values quarterly using the relevant residential property index namely:

Region	Index used
UK	Halifax quarterly regional house price index
Northern Ireland	UK House Price Index (published by the Land Registry)
Republic of Ireland	Central Statistics Office residential property price index

Business review **Capital and risk management**

Credit risk: management basis continued

Counterparty credit risk

RBS mitigates counterparty credit risk arising from both derivatives transactions and repurchase agreements through the use of market standard documentation, enabling netting, and through collateralisation.

Amounts owed by RBS to a counterparty are netted against amounts the counterparty owes RBS, in accordance with relevant regulatory and internal policies. This is only done if a netting agreement is in place.

Risk assessment and monitoring (unaudited)

Practices for credit stewardship including credit assessment, approval and monitoring as well as the identification and management of problem debts differ between the Wholesale and Personal portfolios.

Wholesale customers including corporates, banks and other financial institutions are grouped by industry sectors and geography as well as by product/asset class and are managed on an individual basis.

A credit assessment is carried out before credit facilities are made available to customers. The assessment process is dependent on the complexity of the transaction.

For lower risk transactions below specific thresholds, credit decisions can be approved through self-sanctioning within the business. This is facilitated through an auto-decisioning system, which utilises scorecards, strategies and policy rules to provide a recommended credit decision. Such credit decisions must be within the approval authority of the relevant business sanctioner.

For all other transactions credit is only granted to customers following joint approval by an approver from the business and the credit risk function. Credit risk management is organised in terms of the complexity of the assessment rather than aligned to franchises. The joint business and credit approvers act within a delegated approval authority under the Wholesale Credit Authorities Framework approved by the Executive Risk Forum. The level of delegated authority held by approvers is dependent on their experience and expertise. Only a small number of senior executives hold the highest authority provided under the Wholesale Credit Authorities Framework. Both business and credit approvers are accountable for the quality of each decision taken but the credit risk approver holds ultimate sanctioning authority.

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Transaction Acceptance Standards provide detailed transactional lending and risk acceptance metrics and structuring guidance. Transaction Acceptance Standards are one of the tools used to manage risk appetite at the customer/transaction level and are supplementary to the Credit Policy.

Where the customer is part of a group, the credit assessment considers aggregated credit risk limits for the customer group as well as the nature of the relationship with the broader group (for example parental support) and its impact on credit risk.

Credit relationships are reviewed, and credit grades (PD and LGD) re-approved, annually. The review process assesses borrower performance, including reconfirmation or adjustment of risk parameter estimates; the adequacy of security; compliance with terms and conditions; and refinancing risk.

Personal customers are served through a lending approach that entails making a large number of small-value loans. To ensure that these lending decisions are made consistently, RBS analyses credit information, including the historical debt servicing behaviour of customers with respect to both RBS and their other lenders. RBS then sets its lending rules accordingly, developing different rules for different products.

The process is then largely automated, with customers receiving a credit score that reflects a comparison of their credit profile with the rule set. However, for relatively high-value, complex personal loans, including some residential mortgage lending, specialist credit managers make the final lending decisions.

Underwriting standards are monitored on an ongoing basis to ensure they remain adequate in the current market environment and are not weakened to sustain growth.

A key aspect of credit risk stewardship is ensuring that, when signs of customer stress are identified, appropriate debt management actions are applied.

Problem debt management

Wholesale (unaudited)

Early problem identification

Each segment has defined early warning indicators to identify customers experiencing financial difficulty, and to increase monitoring if needed. Early warning indicators may be internal, such as a customer's bank account activity, or external, such as a publicly-listed customer's share price. If early warning indicators show a customer is experiencing potential or actual difficulty, or if relationship managers or credit officers identify other signs of financial difficulty they may decide to classify the customer within the Risk of Credit Loss framework.

Risk of Credit Loss framework

The framework focuses on Wholesale customers whose credit profiles have deteriorated since origination. Expert judgement is applied by experienced credit risk officers to classify cases into categories that reflect progressively deteriorating credit risk to the bank. There are two classifications which apply to non-defaulted customers within the framework – Heightened Monitoring and Risk of Credit Loss. The framework also applies to those customers that have met the bank's default criteria (AQ10 exposures).

Heightened Monitoring customers are performing customers who have met certain characteristics, which have led to material credit deterioration. Collectively, characteristics reflect circumstances that may affect the customer's ability to meet repayment obligations. Characteristics include trading issues, covenant breaches, material PD downgrades and past due facilities.

Business review **Capital and risk management**

Credit risk: management basis continued

Sector specific characteristics also exist. Heightened Monitoring customers require pre-emptive actions (outside the customer's normal trading patterns) to return or maintain their facilities within the bank's current risk appetite prior to maturity.

Risk of Credit Loss customers are performing customers who have met the criteria for Heightened Monitoring and also pose a risk of credit loss to the bank in the next 12 months, should mitigating action not be taken or not be successful.

Once classified as either Heightened Monitoring or Risk of Credit Loss, a number of mandatory actions are taken in accordance with policies. This includes a review of the customer's credit grade, facility and security documentation and the valuation of security. Depending on the severity of the financial difficulty and the size of the exposure, the customer relationship strategy is reassessed by credit officers, by specialist credit risk or relationship management units in the relevant business or by Restructuring.

Agreed customer management strategies are regularly monitored by both the business and credit teams. The largest Risk of Credit Loss exposures in RBS and in each business are regularly reviewed by a Risk of Credit Loss Committee. The committee members are experienced credit, business and Restructuring specialists. The purpose of the committee is to review and challenge the strategies undertaken for those customers who pose the largest risk of credit loss to the bank.

Appropriate corrective action is taken when circumstances emerge that may affect the customer's ability to service its debt (see Heightened Monitoring characteristics). Corrective actions may include granting a customer various types of concessions. Any decision to approve a concession will be a function of specific country and sector appetite, the credit quality of the customer, the market environment and the loan structure and security. All customers granted forbearance are classified Heightened Monitoring as a minimum.

Other potential outcomes of the relationship review are to: take the customer off the Risk of Credit Loss framework; offer additional lending and continue monitoring; transfer the relationship to Restructuring if appropriate; or exit the relationship altogether.

The Risk of Credit Loss framework does not apply to problem debt management for Business Banking customers in UK PBB. These customers are, where necessary, managed by specialised problem debt management teams, depending on the size of exposure or the Business Banking recoveries team where a loan has been impaired.

Restructuring

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For the Wholesale problem debt portfolio, customer relationships are managed by the Restructuring team (this excludes customers managed by PBB).

The purpose of Restructuring is to protect the bank's capital. Where practicable, Restructuring does this by working with corporate and commercial customers to support their turnaround and recovery strategies and enable them to return to mainstream banking. Restructuring will always aim to recover capital in a fair and efficient manner.

Specialists in Restructuring work with customers experiencing financial difficulties and showing signs of financial stress. Throughout Restructuring's involvement the mainstream relationship manager will remain an integral part of the customer relationship, unless an exit strategy is deemed appropriate. The objective is to find a mutually acceptable solution, including restructuring of existing facilities, repayment or refinancing.

Where a solvent outcome is not possible, insolvency may be considered as a last resort. However, helping the customer return to financial health and restoring a normal banking relationship is always the preferred outcome.

Personal (unaudited)

Personal customers experiencing financial difficulty are managed by the Collections function. If the Collections function is unable to provide appropriate support after discussing suitable options with the customer, management of that customer moves into Recoveries. If at any point in the Collections and Recoveries process, the customer is identified as being potentially vulnerable, the customer will be separated from the regular strategy and supported by a specialist team to ensure the customer receives appropriate support for their circumstances.

Collections

The Collections function takes over management of a customer when the customer exceeds an agreed limit or misses a regular monthly payment. Once in Collections the customer will be supported by skilled debt management staff who will endeavour to provide the customer with solutions based on current circumstances and, where appropriate, any known future changes to their financial position. Solutions include short-term account restructuring, refinance loans and forbearance which can include interest suspension and breathing space. In the event that an affordable/sustainable agreement with a customer cannot be reached, the debt will transition into Recoveries.

In the Republic of Ireland, the relationship may pass to a specialist support team prior to any transfer to recoveries, depending on the outcome of customer financial assessment.

Recoveries

The Recoveries function will issue a notice of intention to default to the customer and, subsequently, a formal demand, while also registering the account with the credit reference agencies where appropriate. Following this, the customer's debt may then be placed with a third-party debt collection agency, or alternatively a solicitor, in order to agree an affordable repayment plan with the customer.

Business review **Capital and risk management**

Credit risk: management basis continued

Forbearance

Forbearance across RBS takes place when a concession is made on the contractual terms of a loan/debt in response to a customer's financial difficulties. Concessions granted where there is no evidence of financial difficulty, or where any changes to terms and conditions are within current risk appetite, or reflect improving credit market conditions for the customer, are not considered forbearance.

The aim of forbearance is to support and restore the customer to financial health while minimising risk. To ensure that forbearance is appropriate for the needs and financial profile of the customer, RBS applies minimum standards when assessing, recording, monitoring and reporting forbearance.

Loans/debt may be forborne more than once, generally where a temporary concession has been granted and circumstances warrant another temporary or permanent revision of the loan's terms.

In the Personal portfolio, loans are considered forborne until they meet the exit criteria set out by the European Banking Authority. These include being classified as performing for two years since the last forbearance event, making regular repayments and the debtor being less than 30 days past due. Exit criteria are not currently applied for Wholesale portfolios.

Types of forbearance

The type of forbearance offered is tailored to the customer's individual circumstances.

In the Wholesale portfolio, forbearance may involve covenant waivers, amendment to margin, payment concessions and loan rescheduling (including extensions in contractual maturity), capitalisation of arrears, and debt forgiveness or debt for equity swap.

In the Personal portfolio forbearance may involve payment concessions and loan rescheduling (including extensions in contractual maturity), capitalisation of arrears and, in the Republic of Ireland only, temporary interest-only conversions. Forbearance is granted principally to customers with mortgages and less frequently to customers with unsecured loans. This includes instances where forbearance may be taken for customers with highly flexible mortgages.

Monitoring of forbearance

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In the Wholesale portfolio, all customers are assigned a PD and related facilities an LGD. These are re-assessed prior to finalising any forbearance arrangement in light of the loan's amended terms. The ultimate outcome of a forbearance strategy is unknown at the time of execution. It is highly dependent on the cooperation of the borrower and the continued existence of a viable business or repayment outcome. Where forbearance is no longer viable, RBS will consider other options such as the enforcement of security, insolvency proceedings or both, albeit these are options of last resort.

For Personal portfolios, forbore loans are separated into a distinct population and reported on a regular basis until they exit the forbore population.

Provisioning for Wholesale forbearance

Provisions for forbore loans are assessed in accordance with normal provisioning policies (refer to impairment loss provision methodology). The customer's financial position and prospects as well as the likely effect of the forbearance, including any concessions granted, and revised PD or LGD gradings, are considered in order to establish whether an impairment provision is required.

Wholesale loans granted forbearance are individually assessed in most cases and are not therefore segregated into a separate risk pool.

Forbearance may result in the value of the outstanding debt exceeding the present value of the estimated future cash flows. This may result in the recognition of an impairment loss or a write-off.

In the case of non-performing forbore loans, the loan impairment provision assessment almost invariably takes place prior to forbearance being granted. The amount of the loan impairment provision may change once the terms of the forbearance are known, resulting in an additional provision charge or a release of the provision in the period the forbearance is granted.

For performing loans, credit metrics are an integral part of the latent provision methodology, and an extended emergence period for forbore loans is applied.

The transfer of wholesale loans from impaired to performing status follows assessment by relationship managers and credit. When no further losses are anticipated and the customer is expected to meet the loan's revised terms, any provision is written off or released and the balance of the loan returned to performing status. This course of action is not dependent on a specified time period and follows the credit risk manager's assessment.

Provisioning for personal forbearance

The methodology used for provisioning in respect of Personal forbore loans will differ depending on whether the loans are performing or non-performing and which business is managing them due to local market conditions.

Granting forbearance will only change the arrears status of the loan in specific circumstances, which can include capitalisation of principal and interest in arrears, where the loan may be returned to the performing book if the customer has demonstrated an ability to meet regular payments and is deemed likely to continue to do so.

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The loan would remain in forbearance for the defined probation period and be subject to performance criteria including making regular repayments and be less than 30 days past due.

Additionally for some forbearance types a loan may be transferred to the performing book if a customer makes payments that reduce loan arrears below 90 days (Ulster Bank RoI and UK PBB collections function).

Business review **Capital and risk management**

For the latent calculation, an extended emergence period is applied to account for the impact of forbearance within the portfolio. Additionally for portfolios with material forbearance, forborne loans form a separate risk pool and use a different PD model. The separate risk pool applies for the duration of the forbearance arrangement and with exit from forbearance segmentation dependent on meeting applicable probationary periods and performance criteria:

- UK PBB (excluding NI): The separate risk pool comprises all forborne loans. The provisioning calculation uses the higher of the observed default rates or PD.
- Ulster Bank RoI: forborne and previously forborne mortgages form separate risk pools. The PD model used is calibrated separately for forborne loans, using information on the historic performance of loans subject to similar arrangements.

For non-performing loans, there is no difference in treatment with the exception of Ulster Bank RoI, where forborne loans which result in an economic loss to the group form a separate risk pool and are subjected to specific provisioning treatments.

Impairment, provisioning and write-offs

In the overall assessment of credit risk, impairment, provisioning and write-offs are used as key indicators of credit quality.

Impairment

A financial asset is impaired if there is objective evidence that the amount, or timing, of future cash flows has been adversely affected. Refer to accounting policies on pages 246 and 247 for details of the quantification of impairment losses.

Days-past-due measures are typically used to identify evidence of impairment. In both the Wholesale and Personal portfolios, a period of 90 days past due is used. In sovereign portfolios, the period used is 180 days past due. Indicators of impairment include the borrower's financial condition; a forbearance event; a loan restructuring; the probability of bankruptcy; or evidence of diminished cash flows.

Provisioning

The amount of an impairment loss is measured as the difference between the asset carrying amount and the present value of the estimated future cash flows discounted at the financial asset's original effective interest rate. The current net realisable value of the collateral will be taken into account in determining the need for a provision. This includes cash flows from foreclosure (less costs of obtaining and selling the collateral), whether or not foreclosure is probable. Impairment provisions are not recognised where amounts due are expected to be settled in full on the realisation of collateral.

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RBS uses one of the following three methods to quantify the provision required: individual, where the quantification method is on a case-by-case assessment of future cash flows; collective, a quantitative review of the relevant portfolio; and latent, where PD, LGD, drawn balance and emergence period are considered in the calculation.

Sensitivity of impairments to assumptions

Key assumptions relating to impairment levels are economic conditions, the interest rate environment, the ease and timing of enforcing loan agreements in varying legal jurisdictions and the level of customer co-operation.

In addition, for secured lending, key assumptions relate to the valuation of the security and collateral held, as well as the timing and cost of asset disposals based on underlying market depth and liquidity. Assessments are made by relationship managers on a case-by-case basis for individually-assessed provisions and are validated by credit teams. Impairments less than £1 million are approved by credit officers under their delegated authority. For individual impairments greater than £1 million, oversight is provided by the RBS Provisions Committee.

Available-for-sale portfolios

Available-for-sale portfolios are also regularly reviewed for evidence of impairment, including: default or delinquency in interest or principal payments; significant financial difficulty of the issuer or obligor; and increased likelihood that the issuer will enter bankruptcy or other financial reorganisation.

Determining whether evidence of impairment exists requires the exercise of management judgement. It should be noted that the following factors are not, of themselves, evidence of impairment, but may be evidence of impairment when considered with other factors:

- Disappearance of an active market because an entity's financial instruments are no longer publicly traded.
- A downgrade of an entity's credit rating.
- A decline in the fair value of a financial asset below its cost or amortised cost.

Write-offs

Impaired loans and receivables are written-off when there is no longer any realistic prospect of recovery of part, or the entire loan. For loans that are individually assessed for impairment, the timing of write-off is determined on a case-by-case basis. Such loans are reviewed regularly and write-offs may be prompted by bankruptcy, insolvency, forbearance and similar events. For details of the typical time frames, from initial impairment to write off, for collectively assessed portfolios refer to the accounting policies section on pages 246 and 247.

Amounts recovered after a loan has been written-off are credited to the loan impairment charge for the period in which they are received.

Business review Capital and risk management

Credit risk: management basis continued

Portfolio summaries

The table below summarises current and potential exposure, by sector and asset quality. The table is unaudited except for forbearance, which is audited.

	Exposure					Portfolio and asset quality as a percentage of total current exposure				
	Personal	Banks and other	Wholesale (1)			Personal	Banks and other	Wholesale (1)		
			Sovereigns (2)	Other	Total			Personal	Sovereigns (2)	Other
£m	£m	£m	£m	£m	£m	%	%	%	%	%
2017										
AQ1-AQ4	118,234	34,263	147,517	42,696	342,710	25	7	31	9	72
AQ5-AQ8	52,836	3,483	59	67,444	123,822	11	1		14	26
AQ9	2,282	27		684	2,993					
AQ10	3,284	36		2,967	6,287	1			1	2
Total current exposure	176,636	37,809	147,576	113,791	475,812	37	8	31	24	100
Total potential exposure	182,492	68,038	148,457	171,858	570,845					
Risk of Credit Loss (3)	n/a	88		571	659					
Forbearance stock (4,5)	4,461	13		3,385	7,859					
Flow into forbearance (4,6)	649	11		1,640	2,300					
Of which:										
- Performing	274	10		1,196	1,480					
- Non-performing	375	1		444	820					
Provisions (7)	2,065	71		1,678	3,814					
2016										
AQ1-AQ4	111,899	42,903	118,049	49,121	321,972	24	9	26	11	70
AQ5-AQ8	47,992	4,392	135	72,340	124,859	10	1		16	27
AQ9	2,622	32	4	591	3,249	1				1
AQ10	3,693	355		3,465	7,513	1			1	2
Total current exposure	166,206	47,682	118,188	125,517	457,593	36	10	26	28	100
Total potential exposure	172,607	84,300	119,056	185,291	561,254					
Risk of Credit Loss (3)	n/a	1	4	851	856					
Forbearance stock (4,5)	5,284	63	1	4,213	9,561					
Flow into forbearance (4,6)	834	5	1	3,232	4,072					
Of which:										
- Performing	447	3		1,782	2,232					

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- Non-performing	387	2	1	1,450	1,840
Provisions (7)	2,192	58	1	2,204	4,455
Year-on-year movements					
Foreign exchange impact					
- increase/(decrease)	539	(578)	618	(758)	(179)
Current exposure					
- constant currency basis	166,745	47,104	118,806	124,759	457,414

Notes:

- (1) Includes SME customers managed in the Business Banking segment of UK PBB who are assigned a sector under RBS' s sector concentration framework.
- (2) Includes exposure to central governments, central banks and sub-sovereigns such as local authorities.
- (3) Excludes Private Banking, Lombard and Invoice Finance exposures which are not material in context of the Risk of Credit Loss portfolio.
- (4) Audited.
- (5) Wholesale forbearance stock represents loans that have been subject to a forbearance event in the two years up to the reporting date. Personal forbearance is aligned to European Banking Authority requirements.
- (6) Completed during the year.
- (7) Provision (including latent).

Business review **Capital and risk management**

Credit risk: management basis [continued](#)

Key points (unaudited)

- Measured against RBS's asset quality scale, as at 31 December 2017, 72% of total current exposure was rated in the AQ1-AQ4 bands, equating to an indicative investment grade rating of BBB- or above (2016 70%). Across the Personal lending exposure, 67% was in the AQ1-AQ4 category (67% as at 31 December 2016). The loan-to-value (LTV) ratio of the mortgage portfolio was 57% (2016 58%).
- The increase in current exposure in the Personal portfolio mainly resulted from growth in UK mortgage lending and was within risk appetite. For further information, refer to page 187.
- The UK unsecured lending portfolio remained broadly stable in size.
- The increase in current exposure across the Wholesale portfolio reflected increases in the Sovereign sector resulting from liquidity management activities. This was offset by decreases in the Banks and other FIs portfolio, which reflected receipt of higher collateral against traded products and by decreases in Transport particularly Shipping in line with the exit strategy for this sector.
- Credit quality, measured against RBS's asset quality scales marginally improved across the Wholesale and Personal portfolios, reflecting resilient market conditions during the period.
- The level of Wholesale and Personal provisions decreased. This reflected progress in reducing defaulted facilities. The Personal portfolio also benefited from house price improvements.
- Exposure classified as Risk of Credit Loss decreased over 2017. This decrease was driven by the Shipping sector as a result of the reclassification of customers to Heightened Monitoring and portfolio disposals (refer to page 192 for further information).
- Wholesale forbearance decreased significantly over 2017. This was driven by lower levels of new forbearance in the Commercial Real Estate and Shipping sectors. Additionally a number of Shipping facilities which were previously forborne were exited during 2017. (Refer to page 192 for further information).
- Loans totalling £1.4 billion were granted approval for forbearance in 2017 but had not yet reached legal completion at 31 December 2017 (2016 £1.4 billion). These exposures are referred to as in process and are not included in the tables on the previous page. 71% (£1.0 billion) of these in process exposures related to non-performing customers and 29% (£0.4 billion) related to performing loans. The principal types of arrangements offered were payment concessions and loan rescheduling.
- £1.1 billion of wholesale forbearance related to payment concessions and £0.5 billion to non-payment concessions. Previously reported forbearance types are classified as non-payment (covenant concessions, release of security) and payment (payment concessions and loan rescheduling, forgiveness of all or part of the outstanding debt, variation in margin, standstill agreements).

[Portfolio overview](#) [geography](#)

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The table below summarises both current and potential exposure, by geographic region.

	Wholesale (1)					Wholesale (1)					Potential exposure Total £m
	Personal £m	Banks and other FIIs £m	Sovereigns (2) £m	Other wholesale £m	Current exposure £m	Personal %	Banks and other FIIs %	Sovereigns (2) %	Other wholesale %		
2017											
UK	158,965	17,992	91,161	94,896	363,014	33	4	19	20	76	413,378
RoI	15,319	751	2,416	4,612	23,098	3		1	1	5	24,502
Other Western											
Europe	514	7,504	43,414	8,559	59,991		2	9	2	13	86,866
US	377	6,987	8,430	2,580	18,374		1	2	1	4	31,497
RoW (3)	1,461	4,575	2,155	3,144	11,335		1		1	2	14,602
Total	176,636	37,809	147,576	113,791	475,812	36	8	31	25	100	570,845
2016											
UK	148,882	19,393	69,390	101,197	338,862	34	4	15	22	75	391,369
RoI	15,079	433	2,387	4,565	22,464	3		1	1	5	23,771
Other Western											
Europe	528	9,978	36,603	10,100	57,209		2	8	2	12	86,660
US	329	11,116	7,338	3,607	22,390		2	2	1	5	38,177
RoW (3)	1,388	6,762	2,470	6,048	16,668		1	1	1	3	21,277
Total	166,206	47,682	118,188	125,517	457,593	37	9	27	27	100	561,254

Notes:

(1) Includes SME customers managed in UK PBB Business Banking who are assigned a sector under RBS's sector concentration framework.

(2) Includes exposures to central governments, central banks and sub-sovereigns such as local authorities.

(3) RoW: Rest of world, which also includes supranationals such as the World Bank and exposure relating to ocean-going vessels which cannot be meaningfully assigned to specific countries from a country risk perspective.

Key points (unaudited)

- The growth in the portfolio is mainly driven by an increase in UK exposures, which is in line with strategy and within risk appetite.
- Sovereign exposure in the UK and Western Europe (predominantly Germany) increased and reflects liquidity management transactions.
- Exposure to the US and RoW decreased as RBS continued to focus on its core markets. The movement includes RBS exiting from the Shipping sector.

Business review Capital and risk management

Credit risk: management basis continued

Overview of the Personal portfolio split by product type and segment on a current exposure basis (unaudited)

	2017					2016*				
	UK PBB	Ulster Bank RoI	Private Banking	RBS International	Total	UK PBB	Ulster Bank RoI	Private Banking	RBS International	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Mortgages	136,473	14,444	8,416	2,722	162,055	127,896	14,396	7,168	2,637	152,097
Year-on-year movement	8,577	48	1,248	85	9,958					
Of which:										
Interest only variable rate	11,190	245	4,072	616	16,123	13,011	349	3,625	692	17,677
Interest only fixed rate	12,578	7	2,867	96	15,548	12,318	7	2,290	81	14,696
Mixed (capital and interest only)	6,027	70		20	6,117	6,003	75		23	6,101
Buy-to-let	17,844	1,646	1,146	923	21,559	18,105	1,777	770	881	21,533
Provisions	153	909	7	27	1,096	174	919	2	27	1,122
REIL	734	3,027	28	89	3,878	837	3,144	23	84	4,088
Other lending (1)	10,247	305	1,470	64	12,086	9,920	291	1,730	64	12,005
Year-on-year movement	327	14	(260)		81					
Provisions	833	44	19	2	898	947	48	18	1	1,014
REIL	810	44	49	5	908	977	50	61	5	1,093
Total lending	146,720	14,749	9,886	2,786	174,141	137,816	14,687	8,898	2,701	164,102
Year-on-year movement	8,904	62	988	85	10,039					
Mortgage LTV ratios (2)										
- Total portfolio	56%	69%	55%	58%	57%	56%	76%	54%	57%	58%
- Performing	56%	65%	55%	56%	57%	56%	72%	54%	55%	57%
- Non-performing	57%	88%	59%	122%	78%	60%	94%	62%	117%	79%

* Re-presented to reflect the segmental reorganisation.

Notes:

(1) Excludes loans guaranteed by a company and commercial real estate lending to personal customers.

(2) Weighted by current exposure gross of provisions.

Key points (unaudited)

- The overall credit risk profile of the Personal portfolio, and its performance against credit risk appetite, remained stable during 2017.
- The increase in Personal portfolio lending was primarily driven by growth in mortgages; mainly in UK PBB.
- New mortgage lending was broadly inline with the levels seen in 2016. The portfolio was closely monitored against an agreed set of risk appetite parameters, which included loan-to-value, loan-to-income, buy-to-let, new-build concentrations and credit quality. This ensured that the portfolio remained appropriate for market conditions. Underwriting standards were maintained during the period.
- Most of the mortgage growth was in the owner-occupied portfolio. In line with market trends, new mortgages in the buy-to-let portfolio decreased as tax and regulatory changes in the UK affected borrower activity.
- The mortgage portfolio loan-to-value ratio remained largely stable. The improvement in Ulster Bank RoI reflected house price recovery.
- Overall the proportion of mortgages by value on interest-only and mixed terms (capital and interest only) reduced, reflecting a move to repayment mortgages and repayment of legacy mortgages. There was a marginal increase in interest only mortgages in Private Banking which reflected increased lending to high net worth individuals.
- 43% of mortgage lending was in London and the South East (2016 44%). New business in this region reduced as a result of lower demand for both buy-to-let and owner-occupied properties. Average weighted loan-to-value for this region was 51% (2016 55%).
- Total provision and forbearance against mortgages continued to decrease. This reflected the relatively low-interest-rate environment in the UK and house price growth as well as a focus on the ability of customers to repay in a sustainable manner over the term of the facility.
- Unsecured lending balances remained broadly stable despite an upward trend in the wider UK market. Growth in the unsecured loan portfolio was offset by declines in the cards and overdrafts portfolios. The reduction in the cards portfolio reflected RBS's decision to abstain from the 0% credit card balance transfer market.
- The total provision for unsecured lending reduced, reflecting the exit from defaulted debt.

Business review Capital and risk management

Credit risk: management basis *continued*

Overview of new mortgage lending on a current exposure basis as at drawdown (unaudited)

	UK PBB	Ulster Bank Rol	Private Banking	RBS International	Total
	£m	£m	£m	£m	£m
2017					
Gross new mortgage lending (1)	30,314	890	2,243	481	33,928
Of which:					
Interest only variable rate	335	6	902	39	1,282
Interest only fixed rate	1,835	1	874	48	2,758
Mixed (capital and interest only)	893				893
Owner occupied	28,504	875	1,904	319	31,602
Average LTV by weighted value	70%	75%	63%	70%	70%
Buy-to-let	1,810	15	339	162	2,326
Average LTV by weighted value	62%	57%	56%	62%	61%
2016*					
Gross new mortgage lending (1)	31,183	893	3,291	470	35,837
Of which:					
Interest only variable rate	1,033		1,766	37	2,836
Interest only fixed rate	2,889		917	32	3,838
Mixed (capital and interest only)	801			3	804
Owner occupied	26,919	876	2,819	300	30,914
Average LTV by weighted value	71%	74%	55%	69%	70%
Buy-to-let	4,264	17	472	170	4,923
Average LTV by weighted value	62%	59%	54%	62%	61%

* Re-presented to reflect the segmental reorganisation.

Note:

(1) For 2016, Private Banking includes additional lending of £1.5 billion. Following a change in methodology, this additional lending is excluded from 2017 data.

Personal portfolio forbearance on a current exposure basis

	UK PBB	Ulster Bank Rol	Private Banking	RBS International	Total
	£m	£m	£m	£m	£m
2017					
Forbearance flow	432	181	31	5	649
Forbearance stock	1,332	3,101	7	21	4,461
Forbearance stock: arrears					
Current	822	1,536	6	12	2,376
1-3 months in arrears	293	387		2	682
> 3 months in arrears	217	1,178	1	7	1,403
Provisions against forbearance stock	51	792		4	847
Forbearance type: (1)					
Long-term arrangement (2)	746	1,048	6	18	1,818
Short-term arrangement (3)	875	2,053	1	3	2,932
2016*					
Forbearance flow	459	316	49	10	834
Forbearance stock	1,467	3,709	65	43	5,284
Forbearance stock: arrears					
Current	897	2,077	65	29	3,068
1-3 months in arrears	327	473		2	802
> 3 months in arrears	243	1,159		12	1,414
Provisions against forbearance stock	59	790		1	850
Forbearance type: (1)					
Long-term arrangement (2)	812	1,249	63	37	2,161
Short-term arrangement (3)	970	2,460	2	6	3,438

* Re-presented to reflect the segmental reorganisation.

Notes:

- (1) Can include multiple arrangements.
- (2) Capitalisation term extensions, economic concessions.
- (3) Payment concessions, amortising payments of outstanding balances, payment holidays and temporary interest arrangements.

Business review Capital and risk management

Credit risk: management basis continued

Mortgage LTV distribution by segment on a current exposure basis

LTV ratio value (1)	50% 80% 100%					Total £m	Weighted average LTV %	Other £m	Total £m
	<=50% £m	<=80% £m	<=100% £m	<=150% £m	>150% £m				
2017									
Total RBS									
AQ1-AQ8	57,839	78,813	18,645	1,181	53	156,531	56	621	157,152
AQ9	332	761	417	269	6	1,785	75	5	1,790
AQ10	849	1,201	499	518	29	3,096	78	17	3,113
	59,020	80,775	19,561	1,968	88	161,412	57	643	162,055
Of which:									
UK PBB									
AQ1-AQ8	50,487	67,553	15,882	294	24	134,240	56	508	134,748
AQ9	81	301	79	7	2	470	66	4	474
AQ10	523	614	80	16	4	1,237	57	14	1,251
	51,091	68,468	16,041	317	30	135,947	56	526	136,473
Ulster Bank Rol									
AQ1-AQ8	3,510	4,990	2,079	864	14	11,457	63		11,457
AQ9	232	428	335	262	4	1,261	79		1,261
AQ10	306	531	395	477	17	1,726	88		1,726
	4,048	5,949	2,809	1,603	35	14,444	69		14,444
2016*									
Total RBS									
AQ1-AQ8	54,334	71,240	17,311	2,212	92	145,189	57	943	146,132
AQ9	335	760	492	636	13	2,236	87	6	2,242
AQ10	904	1,461	545	728	57	3,695	79	28	3,723
	55,573	73,461	18,348	3,576	162	151,120	58	977	152,097
Of which:									
UK PBB									
AQ1-AQ8	47,818	61,958	14,691	397	52	124,916	56	711	125,627
AQ9	79	295	102	10	3	489	68	4	493
AQ10	629	925	173	25	5	1,757	60	19	1,776
	48,526	63,178	14,966	432	60	127,162	56	734	127,896
Ulster Bank Rol									

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AQ1-AQ8	2,844	4,133	2,185	1,766	14	10,942	70	10,942
AQ9	237	417	372	614	8	1,648	88	1,648
AQ10	252	461	355	691	47	1,806	94	1,806
	3,333	5,011	2,912	3,071	69	14,396	76	14,396

* Re-presented to reflect the segmental reorganisation.

Note:

(1) LTV is calculated on a current exposure basis, gross of provisions.

Business review Capital and risk management

Credit risk: management basis continued

UK PBB mortgage exposure by region and LTV on a current exposure basis

LTV ratio value	50% 80% 100%					Total £m	Weighted average LTV %	Other £m	Total £m
	<=50% £m	<=80% £m	<=100% £m	<=150% £m	>150% £m				
2017									
South East	14,603	16,902	2,728	10		34,243	53	96	34,339
Greater London	13,589	9,897	1,322	3		24,811	48	113	24,924
Scotland	2,849	5,336	2,415	42		10,642	63	35	10,677
North West	4,124	7,497	2,118	9		13,748	59	62	13,810
South West	4,181	6,568	1,054	9		11,812	56	40	11,852
West Midlands	2,577	5,259	1,499	6		9,341	61	42	9,383
Rest of the UK	9,168	17,009	4,905	238	30	31,350	60	138	31,488
Total	51,091	68,468	16,041	317	30	135,947	56	526	136,473
2016*									
South East	13,955	15,955	2,181	13		32,104	53	155	32,259
Greater London	13,729	9,328	939	4		24,000	47	160	24,160
Scotland	2,955	5,290	1,918	46		10,209	61	51	10,260
North West	3,651	6,848	2,362	21		12,882	61	74	12,956
South West	3,826	6,005	995	13		10,839	56	62	10,901
West Midlands	2,277	4,729	1,396	7		8,409	61	48	8,457
Rest of the UK	8,133	15,023	5,175	328	60	28,719	62	184	28,903
Total	48,526	63,178	14,966	432	60	127,162	56	734	127,896

* Re-presented to reflect the segmental reorganisation

Commercial real estate (CRE) (unaudited)

The CRE portfolio comprises exposures to entities involved in the development of, or investment in, commercial and residential properties (including house builders but excluding housing associations, construction and building materials).

The sector is reviewed regularly at senior executive committees. Reviews include portfolio credit quality, capital consumption and control frameworks.

CRE exposure by sub-sector on a current exposure basis (unaudited)

By geography and sub-sector (1)	2017				2016			
	UK £m	Rol £m	Other £m	Total £m	UK £m	Rol £m	Other £m	Total £m
Investment								
Residential	4,173	222	28	4,423	3,762	70	37	3,869
Office	2,944	233	599	3,776	3,173	128	574	3,875
Retail	5,318	41	130	5,489	4,802	48	58	4,908
Industrial	2,377	35	14	2,426	2,657	30	52	2,739
Mixed/other	4,635	190	158	4,983	6,141	253	234	6,628
	19,447	721	929	21,097	20,535	529	955	22,019
Development								
Residential	3,008	112	151	3,271	3,127	133	44	3,304
Office	114			114	149	26		175
Retail	249	4	2	255	168		2	170
Industrial	49			49	39	3	13	55
Mixed/other	66	3		69	11	20		31
	3,486	119	153	3,758	3,494	182	59	3,735
Total	22,933	840	1,082	24,855	24,029	711	1,014	25,754

Note:

(1) Geography splits are based on country of collateral risk.

Business review **Capital and risk management**

Credit risk: management basis *continued*

Key points (unaudited)

- The majority of the CRE exposure is managed by Commercial & Private Banking. The reduction in exposure over the period is the result of the successful implementation of distribution and capital market activity, in line with business strategy.
- The commercial real estate market performed far better in 2017 than had been expected by most at the start of the year. Investment activity was 20% up on 2016 and just 10% short of the record level reached in 2015. A notable factor was the influx of capital from China, estimated at over £10 billion, equating for approximately 15% of the total market.
- Much of this capital was targeted at the London office market, helping to support values despite the ongoing risks associated with exiting the European Union. The industrial market was the standout performer, supported by growing demand for logistics capacity. At the other end of the scale, the retail sector continued to feel the effect of online sales growth, with secondary shopping centres particularly at risk from falling tenant demand.
- As a result of wider ongoing economic uncertainty, tightened underwriting standards were maintained, with further tightening of appetite in certain asset classes and sub-sectors throughout the year.
- The core strategy for CRE in the Republic of Ireland is in line with the wider Ulster Bank Rol strategy to support the Irish economy with some controlled growth of the balance sheet over the upcoming years, within risk appetite.

Commercial Banking UK investment portfolio by UK region on a current exposure basis (unaudited)

UK region	2017		2016	
	£m	%	£m	%
Greater London	3,535	27	3,816	27
Multiple locations (1)	2,753	22	2,976	22
South East	1,512	12	1,650	12
Midlands	1,520	12	1,767	13
North	1,465	12	1,635	12
Scotland	960	8	1,006	7
Rest of UK	829	7	915	7

Note:

(1) Lending secured against property portfolios with multiple assets across the UK.

CRE loan-to-value ratio on a current exposure basis

Loan-to-value	2017			2016		
	AQ1-AQ9 £m	AQ10 £m	Total £m	AQ1-AQ9 £m	AQ10 £m	Total £m
<= 50%	9,608	54	9,662	10,695	53	10,748
> 50% and <= 70%	6,631	105	6,736	6,508	120	6,628
> 70% and <= 90%	483	81	564	773	124	897
> 90% and <= 100%	83	21	104	130	41	171
> 100% and <= 110%	34	16	50	74	24	98
> 110% and <= 130%	67	407	474	136	357	493
> 130% and <= 150%	45	23	68	82	28	110
> 150%	74	31	105	108	61	169
Total with LTVs	17,025	738	17,763	18,506	808	19,314
Total portfolio average LTV (1)	47%	119%	51%	48%	113%	51%
Other (2)	3,023	311	3,334	2,356	349	2,705
Development (3)	3,610	148	3,758	3,555	180	3,735
	23,658	1,197	24,855	24,417	1,337	25,754

Notes:

- (1) Weighted average by current exposure gross of provisions.
- (2) Relates predominantly to business banking, rate risk management products and unsecured corporate lending.
- (3) Relates to the development of commercial and residential properties. LTV is not a meaningful measure for this type of lending activity.

Business review Capital and risk management

Credit risk: management basis *continued*

CRE asset quality on a current exposure basis (unaudited)

	2017 £m	2016 £m
AQ1-AQ4	7,609	7,671
AQ5-AQ8	15,960	16,638
AQ9	90	108
AQ10	1,196	1,337
Total	24,855	25,754
Forbearance flow	302	524
Risk of Credit Loss	108	50
Provision (including latent)	334	544

Shipping on a current exposure basis (unaudited)

Exposure to the shipping sector is summarised below.

	2017 £m	2016 £m
AQ1-AQ4	1,159	1,504
AQ5-AQ8	869	2,158
AQ9		24
AQ10	483	867
Total	2,511	4,553
Forbearance flow		723
Risk of Credit Loss	23	362
Provision	168	394

Key points (unaudited)

- The majority of the Shipping portfolio relates to loans or finance leases secured by ocean-going vessels. The remaining exposure relates principally to Ports, Shipbuilding and Inland Water Transport sub sectors. In line with RBS's exit strategy for this portfolio the reduction in

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exposure during 2017 was largely driven by asset sales and debt repayment on the ship finance product; with other exposure remaining largely stable.

- The key component of the AQ1-AQ4 exposure banding is a portfolio of long-dated finance leases, financing ships to investment-grade oil majors and shipping companies.
- The most significant movement in exposure during 2017 was in the AQ5-AQ8 banding where the bulk of the ship finance debt portfolio lies. The reduction in exposure was mainly as a result of asset disposals resulting from the exit strategy.
- Continued progress in managing down the defaulted portfolio resulted in lower AQ10 exposure, with very few new transfers into the category during 2017.
- The weakness in the dry bulk and container shipping markets generated a high level of forbearance activity in 2016. However, a recovery in those markets, particularly in dry bulk, during 2017 limited the flow into forbearance. Fewer forbearance concessions were granted and these related to smaller exposures. The market recovery as well as clients, in general, continuing to support their shipping investments in terms of maintaining debt service and security cover covenants allowed RBS to remove a number of transactions from risk of loss status during the year.

Business review Capital and risk management

Credit risk: management basis continued

Balance sheet to current exposure bridge (unaudited)

The table below provides a bridge between the balance sheet and the related components of current exposure (CE).

	Balance sheet	Within the scope of market risk (1)	Disposal groups (2)	Netting and collateral (3)	Methodology differences and reclassifications (4)	Not within the scope of CE (5)	CE
	£bn	£bn	£bn	£bn	£bn	£bn	£bn
2017							
Cash and balances at central banks	98.3					(3.4)	94.9
Reverse repurchase agreements and stock borrowing (6)	40.7			(34.2)		(4.4)	2.2
Loans and advances	339.4	(0.3)		(21.6)	(9.0)	(3.9)	304.6
Debt securities	78.9	(27.4)			0.2		51.6
Equity shares	0.5					(0.5)	
Settlement balances	2.5					(2.5)	
Derivatives	160.8			(149.5)			11.3
Other assets (7)	16.8					(15.5)	1.3
Total assets	738.0	(27.7)		(205.3)	(8.9)	(30.2)	465.9
Contingent obligations							9.9
							475.8
2016							
Cash and balances at central banks	74.3				(0.6)	(4.2)	69.5
Reverse repurchase agreements and stock borrowing (6)	41.8			(39.4)			2.4
Loans and advances	340.3	(0.2)		(24.4)	(8.4)	(1.7)	305.6
Debt securities	72.5	(24.4)			0.4		48.5
Equity shares	0.7	(0.2)			(0.5)		(0.0)
Settlement balances	5.5					(5.5)	
Derivatives	247.2			(226.8)	(1.4)		19.0
Other assets (7)	16.8					(15.5)	1.3
Total assets	799.1	(24.8)		(290.6)	(10.5)	(26.9)	446.3
Contingent obligations							11.3
							457.6

Notes:

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- (1) The exposures in regulatory trading book businesses are subject to market risk and are hence excluded from current exposure.
- (2) Amounts reclassified to balance sheet lines.
- (3) Primarily includes:
 - Reverse repos: reflects netting of collateral and cash legs.
 - Loans and advances: cash collateral pledged with counterparties in relation to net derivative liability positions.
 - Derivatives: impact of master netting arrangements.
- (4) Primarily includes cash management pooling arrangements not allowed under IFRS for loans and advances.
 - Settlement balances: exposure not included in current exposure measure
- (5) Primarily includes cash in ATMs and branches; Other assets (see note below); and Settlement balances (not within the scope of current exposure).
- (6) Balance sheet position shows reverse repurchase and stock borrowing position; current exposure position shows net reverse repurchase/stock borrowing and repurchase/stock lending position.
- (7) Balance sheet position includes intangible assets, property, plant and equipment, deferred tax, prepayments and accrued income and assets of disposal groups.

Business review Capital and risk management

Credit risk: balance sheet analysis

Current and Potential Exposures presented in Credit risk: management basis are used by Group Credit Risk Management for risk management and monitoring. However, they exclude certain exposures, primarily trading securities and take account of legal netting agreements that provide a right of legal set-off but do not meet the offset criteria in IFRS. The tables that follow are therefore provided to supplement the disclosures in the Credit risk: management basis section, to reconcile to the balance sheet. The tables in this section include balances relating to disposal groups, reflecting the total credit risk and losses faced by RBS. All the disclosures in this section are audited.

Financial assets

Exposure summary and credit mitigation

The following table analyses financial asset exposures, both gross and net of offset arrangements, as well as credit mitigation and enhancement.

	Gross exposure	IFRS offset (1)	Carrying value (2)	Balance sheet offset (3)	Collateral (4)					Exposure post credit mitigation and enhancement
					Cash (5)	Securities (6)	Real estate and other Residential (7)	Commercial (7)	Credit enhancement (8)	
	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
2017										
Cash and balances at central banks	98.4		98.4							98.4
Reverse repos	84.7	(44.0)	40.7	(0.3)		(40.4)				
Lending	340.6	(1.1)	339.5	(27.9)	(0.9)	(3.3)	(174.2)	(45.0)	(2.1)	86.1
Debt securities	78.9		78.9					(0.1)		78.8
Equity shares	0.5		0.5							0.5
Derivatives	177.9	(17.1)	160.8	(128.3)	(20.3)	(5.9)			(6.3)	
Settlement balances	3.2	(0.7)	2.5							2.5
Total	784.2	(62.9)	721.3	(156.5)	(21.2)	(49.6)	(174.2)	(45.1)	(8.4)	266.3
Short positions	(28.5)		(28.5)							(28.5)
Net of short positions	755.7	(62.9)	692.8	(156.5)	(21.2)	(49.6)	(174.2)	(45.1)	(8.4)	237.8
2016										
Cash and balances at central banks	74.3		74.3							74.3
Reverse repos	73.5	(31.7)	41.8	(1.1)		(40.7)				
Lending	340.9	(0.6)	340.3	(29.8)	(0.8)	(3.5)	(154.3)	(52.8)	(2.1)	97.0
Debt securities	72.5		72.5							72.5
Equity shares	0.7		0.7							0.7

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Derivatives	298.1	(51.1)	247.0	(197.3)	(28.7)	(8.4)			(12.6)	
Settlement balances	7.0	(1.5)	5.5							5.5
Total	867.0	(84.9)	782.1	(228.2)	(29.5)	(52.6)	(154.3)	(52.8)	(14.7)	250.0
Short positions	(22.1)		(22.1)							(22.1)
Net of short positions	844.9	(84.9)	760.0	(228.2)	(29.5)	(52.6)	(154.3)	(52.8)	(14.7)	227.9

Notes:

- (1) Relates to offset arrangements that comply with IFRS criteria and transactions cleared through and novated to central clearing houses, primarily London Clearing House and US Government Securities Clearing Corporation. During 2016 and 2017, changes in the legal contracts with LCH and CME led to many derivatives cleared through that counterparty being settled to market each day rather than being collateralised as previously. This led to the derecognition of the associated assets and liabilities.
- (2) The carrying value on the balance sheet represents the exposure to credit risk by class of financial instrument.
- (3) The amount by which credit risk exposure is reduced through arrangements, such as master netting agreements and cash management pooling, which give RBS a legal right to set off the financial asset against a financial liability due to the same counterparty.
- (4) RBS holds collateral in respect of individual loans and advances to banks and customers. This collateral includes mortgages over property (both personal and commercial); charges over business assets such as plant, inventories and trade debtors; and guarantees of lending from parties other than the borrower. RBS obtains collateral in the form of securities in reverse repurchase agreements. Cash and securities are received as collateral in respect of derivative transactions.
- (5) Includes cash collateral pledged by counterparties based on daily mark-to-market movements of net derivative positions with the counterparty.
- (6) Represent the fair value of securities received from counterparties, mainly relating to reverse repo transactions as part of netting arrangements.
- (7) Property valuations are capped at the loan value and reflect the application of haircuts in line with regulatory rules to indexed valuations. Commercial collateral includes ships and plant and equipment collateral.
- (8) Comprises credit derivatives (bought protection) and guarantees against exposures.

Key points

- The majority of the £237.8 billion net exposure comprises cash and balances at central banks, unsecured commercial and personal bank lending and sovereign debt securities.
- Net exposure increased by £9.9 billion reflecting higher cash placements with UK and Eurozone central banks and higher debt securities

Business review Capital and risk management

Credit risk: balance sheet analysis continued

Sector concentration

The following table analyses financial assets by industry sector.

	Reverse		Securities			Other financial	Balance sheet value	Offset	Exposure post offset
	repos	Lending	Debt	Equity	Derivatives	assets	£m	£m	£m
	£m	£m	£m	£m	£m	£m	£m	£m	£m
2017									
Central and local government	1,308	4,684	63,070		1,806	20	70,888	(3,356)	67,532
Financial institutions - banks	13,997	16,264	4,062	4	89,972	98,337	222,636	(94,912)	127,724
- other (1)	25,407	30,832	9,895	325	61,824	2,352	130,635	(67,267)	63,368
Personal - mortgages		163,010					163,010		163,010
- unsecured		14,587			15	1	14,603		14,603
Property		33,381	155	2	797		34,335	(1,234)	33,101
Construction		3,798	2		106	10	3,916	(632)	3,284
Manufacturing		8,862	888	107	884	28	10,769	(1,583)	9,186
Finance leases and instalment credit		12,019	2				12,021		12,021
Retail, wholesale and repairs		12,300	33		311	16	12,660	(1,434)	11,226
Transport and storage		4,241	198		549		4,988	(717)	4,271
Health, education and leisure	4	11,337	23		553	5	11,922	(757)	11,165
Hotels and restaurants		6,049	18		31		6,098	(168)	5,930
Utilities		4,172	49		2,564	46	6,831	(1,673)	5,158
Other	16	17,726	566	21	1,431	39	19,799	(3,102)	16,697
Total gross of provisions	40,732	343,262	78,961	459	160,843	100,854	725,111	(176,835)	548,276
Provisions		(3,814)	(28)	(9)			(3,851)	n/a	(3,851)
Total	40,732	339,448	78,933	450	160,843	100,854	721,260	(176,835)	544,425

2016									
Central and local government	219	6,091	58,472		2,521	63	67,366	(5,188)	62,178
Financial institutions - banks	12,860	17,291	3,437	11	145,956	74,250	253,805	(149,941)	103,864
- other (1)	28,407	33,083	9,738	619	88,409	5,290	165,546	(91,395)	74,151
Personal - mortgages		153,319				8	153,327		153,327
- unsecured		14,492			39		14,531		14,531
Property		34,756	148	54	1,051	13	36,022	(1,111)	34,911
Construction		4,247			97	35	4,379	(779)	3,600
Manufacturing	43	9,609	198	12	1,851	18	11,731	(1,083)	10,648

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Finance leases and instalment credit	12,269			3		12,272	(3)	12,269	
Retail, wholesale and repairs	12,823	7		610	2	13,442	(1,610)	11,832	
Transport and storage	6,428	28		1,086		7,542	(971)	6,571	
Health, education and leisure	11,526	17		632	11	12,186	(648)	11,538	
Hotels and restaurants	6,079	6		46		6,131	(181)	5,950	
Utilities	193	3,938	159		3,488	15	7,793	(1,603)	6,190
Other	65	18,818	394	88	1,192	71	20,628	(2,324)	18,304
Total gross of provisions	41,787	344,769	72,604	784	246,981	79,776	786,701	(256,837)	529,864
Provisions		(4,455)	(82)	(81)			(4,618)	n/a	(4,618)
Total	41,787	340,314	72,522	703	246,981	79,776	782,083	(256,837)	525,246

Note:

(1) Includes loans made by consolidated conduits to asset owning companies.

Business review Capital and risk management

Credit risk: balance sheet analysis continued

Asset quality

The asset quality analysis presented below is based on internal asset quality ratings which have ranges for the probability of default. Customers are assigned credit grades, based on various credit grading models that reflect the key drivers of default for the customer type. All credit grades across RBS map to both an asset quality scale, used for external financial reporting, and a master grading scale for wholesale exposures used for internal management reporting across portfolios. Debt securities are analysed by external ratings and are therefore excluded from the following table and are set out on pages 203 to 204.

The table that follows details the relationship between internal asset quality (AQ) bands and external ratings published by Standard & Poor's (S&P), for illustrative purposes only. This relationship is established by observing S&P's default study statistics, notably the one year default rates for each S&P rating grade. A degree of judgement is required to relate the probability of default ranges associated with the master grading scale to these default rates given that, for example, the S&P published default rates do not increase uniformly by grade and the historical default rate is nil for the highest rating categories.

Internal asset quality band	Probability of default range	Indicative S&P rating
AQ1	0% - 0.034%	AAA to AA
AQ2	0.034% - 0.048%	AA to AA-
AQ3	0.048% - 0.095%	A+ to A
AQ4	0.095% - 0.381%	BBB+ to BBB-
AQ5	0.381% - 1.076%	BB+ to BB
AQ6	1.076% - 2.153%	BB- to B+
AQ7	2.153% - 6.089%	B+ to B
AQ8	6.089% - 17.222%	B- to CCC+
AQ9	17.222% - 100%	CCC to C
AQ10	100%	D

The mapping to the S&P ratings is used by RBS as one of several benchmarks for its wholesale portfolios, depending on customer type and the purpose of the benchmark. The mapping is based on all issuer types rated by S&P. It should therefore be considered illustrative and does not, for instance, indicate that exposures reported against S&P ratings either have been or would be assigned those ratings if assessed by S&P. In addition, the relationship is not relevant for retail portfolios, smaller corporate exposures or specialist corporate segments given that S&P does not typically assign ratings to such entities.

	AQ1-AQ4 £bn	AQ5-AQ8 £bn	AQ9 £bn	AQ10 £bn	Past due £bn	Impaired £bn	Impairment provision £bn	Total £bn
2017								
Cash and balances at central banks	98.3							98.3
Banks								

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- Reverse repos	12.1	1.9						14.0
- Derivative cash collateral	6.7	0.2						6.9
- Bank loans	8.9	0.5						9.4
- Total	27.7	2.6						30.3
Customers								
- Reverse repos	26.0	0.7						26.7
- Derivative cash collateral	14.5	0.2						14.7
- Customer loans	186.3	108.7	2.8	0.7	6.4	7.4	(3.8)	308.5
- Total	226.8	109.6	2.8	0.7	6.4	7.4	(3.8)	349.9
Settlement balances and other financial assets	2.2	0.1	0.1	0.1				2.5
Derivatives	153.4	7.4						160.8
Undrawn commitments	78.7	45.6	0.1	0.5				124.9
Contingent liabilities	8.8	2.2		0.1				11.1
Total	595.9	167.5	3.0	1.4	6.4	7.4	(3.8)	777.8
Total %	76.6%	21.5%	0.4%	0.2%	0.8%	1.0%	(0.5%)	100.0%

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Business review Capital and risk management

Credit risk: balance sheet analysis *continued*

	AQ1-AQ4	AQ5-AQ8	AQ9	AQ10	Past due	Impaired	Impairment provision	Total
	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
2016								
Cash and balances at central banks	74.3							74.3
Banks								
- Reverse repos	11.1	1.4	0.4					12.9
- Derivative cash collateral	6.5	0.2						6.7
- Bank loans	10.0	0.4	0.1					10.5
- Total	27.6	2.0	0.5					30.1
Customers								
- Reverse repos	28.3	0.6						28.9
- Derivative cash collateral	16.8	0.2						17.0
- Customer loans	180.6	109.2	4.2	1.0	6.6	8.9	(4.5)	306.0
- Total	225.7	110.0	4.2	1.0	6.6	8.9	(4.5)	351.9
Settlement balances and other financial assets	5.1	0.3		0.1				5.5
Derivatives	234.2	12.8						247.0
Undrawn commitments	88.6	49.3	0.1	0.6				138.6
Contingent liabilities	9.2	2.7		0.1				12.0
Total	664.7	177.1	4.8	1.8	6.6	8.9	(4.5)	859.4
Total %	77.3%	20.7%	0.6%	0.2%	0.7%	1.0%	(0.5%)	100.0%

Business review Capital and risk management

Credit risk: balance sheet analysis continued

Loans, REIL and impairment provisions

Risk elements in lending (REIL) comprises impaired loans and accruing loans past due 90 days or more as to principal or interest. Impaired loans are all loans (including loans subject to forbearance) for which an impairment provision has been established; for collectively assessed loans, impairment loss provisions are not allocated to individual loans and the entire portfolio is included in impaired loans. Accruing loans past due 90 days or more comprise loans past due 90 days where no impairment loss is expected.

Loans and related credit metrics

The tables below analyse gross loans and advances (excluding reverse repos) and related credit metrics by reportable segment.

	Gross loans to		REIL	Provisions	REIL as a% of gross loans to customers	Credit metrics		Provisions as a% of gross loans to customers	Impairment losses/ (releases)	Amounts written-off
	Banks	Customers				as a%	Provisions as a%			
	£m	£m	£m	£m	%	%	%	£m	£m	
2017										
UK PBB	500	162,957	1,975	1,280	1.2	65	0.8	235	572	
Ulster Bank Rol	2,447	20,623	3,282	1,131	15.9	34	5.5	60	124	
Commercial Banking	697	98,182	3,196	1,162	3.3	36	1.2	362	335	
Private Banking	109	13,514	95	32	0.7	34	0.2	6	4	
RBS International	29	8,743	103	35	1.2	34	0.4	3	6	
NatWest Markets	7,490	22,902	253	174	1.1	69	0.8	(137)	167	
Central items & other	4,992	77						1	2	
Total	16,264	326,998	8,904	3,814	2.7	43	1.2	530	1,210	
2016*										
UK PBB	504	154,190	2,372	1,537	1.5	65	1.0	125	521	
Ulster Bank Rol	2,418	20,130	3,513	1,200	17.5	34	6.0	(113)	2,057	
Commercial Banking	582	100,914	1,946	845	1.9	43	0.8	206	577	
Private Banking	111	12,188	105	31	0.9	30	0.3	(3)	3	
RBS International	18	8,812	109	38	1.2	35	0.4	10	6	
NatWest Markets	7,871	30,988	2,264	803	7.3	35	2.6	312	509	
Central items & other	5,787	256	1	1	0.4	100	0.4		22	
Total	17,291	327,478	10,310	4,455	3.1	43	1.4	537	3,695	

* Re-presented to reflect the segmental reorganisation.

Key points

- UK PBB: mortgage growth of £8.8 billion was the principal driver of the gross lending increase in 2017. Impairment losses and write-offs were higher as debt flow into default continues to increase, particularly for loans arising from business written between Q4 2015 and mid 2016.
- Commercial Banking: customer lending decreased by £2.7 billion as a result of active capital management offset by growth in targeted segments. The increase in impairment loss was largely driven by a small number of single name impairments, principally in the second half of 2017.
- Private Banking: lending growth of £1.3 billion primarily on mortgages.
- NatWest Markets: customer lending decreased by £8.0 billion primarily due to disposal activity.
- Central items & other: Short term bank placings declined £0.8 billion.
- REIL were 2.7% of gross lending, down from 3.1% in 2016. This reflected the relatively low-interest-rate environment in the UK and house price growth for personal lending, along with disposal activity of legacy assets within NatWest Markets.
- Provisions coverage of REIL was stable at 43%, but within that write offs, repayments and disposals in REIL were £1.2 billion and £2.7 billion compared with £3.7 billion and £3.3 billion a year ago.
- Total provision fell by £0.6 billion to £3.8 billion principally in legacy NatWest Markets. Commercial Banking provisions increased by £236 million in Q4 2017 reflecting transfer of legacy assets, including Shipping.
- Amounts written off were significantly lower at £1.2 billion compared to £3.7 billion in 2016, primarily in commercial real estate which had £1.3 billion lower write offs in 2017, principally in Ulster Bank RoI.

Business review Capital and risk management

Credit risk: balance sheet analysis continued

Impairment charge and provisions

The tables below analyse the categories of loan impairment losses/(releases) and provisions by reportable segment.

	Impairment losses/(releases)				Impairment provision			
	Individual	Collective	Latent	Total	Individual	Collective	Latent	Total
	£m	£m	£m	£m	£m	£m	£m	£m
2017								
UK PBB	17	212	6	235	34	1,035	211	1,280
Ulster Bank RoI	(8)	72	(4)	60	45	1,010	76	1,131
Commercial Banking	336	32	(6)	362	848	229	85	1,162
Private Banking	5		1	6	26		6	32
RBS International	2		1	3	28		7	35
NatWest Markets	(124)	(1)	(12)	(137)	151	18	5	174
Central items & other	1			1				
Total	229	315	(14)	530	1,132	2,292	390	3,814

2016*									
UK PBB		5	118	2	125	26	1,306	205	1,537
Ulster Bank RoI		(8)	99	(204)	(113)	69	1,053	78	1,200
Commercial Banking		196	3	7	206	479	278	88	845
Private Banking		2		(5)	(3)	27		4	31
RBS International		9		1	10	32		6	38
NatWest Markets		331	(2)	(17)	312	761	23	19	803
Central items & other						1			1
Total		535	218	(216)	537	1,395	2,660	400	4,455

* Re-presented to reflect segmental reorganisation.

Business review Capital and risk management

Credit risk: balance sheet analysis [continued](#)

Sector and geographical concentration

The tables below analyse gross loans and advances to banks and customers (excluding reverse repos) and related credit metrics by sector and geography based on the location of lending office. Ulster Bank RoI contributes a significant proportion of the European loan exposure. Refer to Business review on page 136.

	Gross			REIL	Credit metrics	Provisions	Impairment	Amounts
	loans	REIL	Provisions	as a% of	Provisions	as a% of	losses/	Amounts
	£m	£m	£m	gross loans	of REIL	gross	(releases)	written-off
				%	%	loans	£m	£m
						%		
2017								
Central and local government	4,684							
Finance	30,832	54	44	0.2	81	0.1	3	7
Personal - mortgages (1)	163,010	3,876	994	2.4	26	0.6	50	87
- unsecured	14,587	937	763	6.4	81	5.2	235	424
Property	33,381	1,119	283	3.4	25	0.8	(82)	133
Construction	3,798	426	298	11.2	70	7.8	196	36
<i>of which: commercial real estate</i>	<i>24,784</i>	<i>1,189</i>	<i>293</i>	<i>4.8</i>	<i>25</i>	<i>1.2</i>	<i>(76)</i>	<i>139</i>
Manufacturing	8,862	147	64	1.7	44	0.7	4	25
Finance leases and instalment credit	12,019	170	88	1.4	52	0.7	23	14
Retail, wholesale and repairs	12,300	446	193	3.6	43	1.6	93	81
Transport and storage	4,241	700	195	16.5	28	4.6	(32)	165
Health, education and leisure	11,337	330	145	2.9	44	1.3	65	48
Hotels and restaurants	6,049	193	80	3.2	41	1.3	17	46
Utilities	4,172	35	21	0.8	60	0.5	(18)	13
Other	17,726	471	256	2.7	54	1.4	(10)	131
Latent			390				(14)	
Total	326,998	8,904	3,814	2.7	43	1.2	530	1,210
Of which:								
UK								
Personal - mortgages	147,399	849	137	0.6	16	0.1	(22)	20
- unsecured	14,145	892	721	6.3	81	5.1	229	411
Property and construction	35,985	1,488	528	4.1	35	1.5	131	144
<i>of which: commercial real estate</i>	<i>23,754</i>	<i>1,139</i>	<i>247</i>	<i>4.8</i>	<i>22</i>	<i>1.0</i>	<i>(71)</i>	<i>116</i>
Other	107,654	2,309	908	2.1	39	0.8	142	495
Latent			312				(7)	
Total	305,183	5,538	2,606	1.8	47	0.9	473	1,070
Europe								
Personal - mortgages	15,572	3,027	857	19.4	28	5.5	72	63
- unsecured	442	45	41	10.2	91	9.3	3	11

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Property and construction	1,194	57	52	4.8	91	4.4	(9)	24
<i>of which: commercial real estate</i>	1,030	50	46	4.9	92	4.5	(5)	23
Other	4,054	191	133	4.7	70	3.3	(9)	31
Latent			78				(6)	
Total	21,262	3,320	1,161	15.6	35	5.5	51	129
Total banks	16,264							

Note:

(1) Mortgages are reported in sectors other than personal mortgages by certain businesses based on the nature of the relationship with the customer.

For commentary on residential mortgages and commercial real estate see Credit risk management basis section

Business review Capital and risk management

Credit risk: balance sheet analysis continued

	Gross		REIL		Credit metrics		Impairment losses/ (release) £m	Amounts written-off £m
	loans £m	REIL £m	Provisions £m	as a% of gross loans %	Provisions as a% of REIL %	Provisions as a% of gross loans %		
2016	£m	£m	£m	%	%	%	£m	£m
Central and local government	6,091	1	1		100		1	2
Finance	33,083	61	51	0.2	84	0.2	(2)	17
Personal - mortgages (1)	153,319	4,091	1,019	2.7	25	0.7	222	290
- unsecured	14,492	1,113	900	7.7	81	6.2	138	396
Property	34,756	1,370	489	3.9	36	1.4	(162)	1,485
Construction	4,247	264	137	6.2	52	3.2	8	153
<i>of which: commercial real estate</i>	<i>26,265</i>	<i>1,407</i>	<i>511</i>	<i>5.4</i>	<i>36</i>	<i>1.9</i>	<i>(184)</i>	<i>1,483</i>
Manufacturing	9,609	173	90	1.8	52	0.9	13	90
Finance leases and instalment credit	12,269	139	79	1.1	57	0.6	8	12
Retail, wholesale and repairs	12,823	283	182	2.2	64	1.4	39	169
Transport and storage	6,428	1,388	422	21.6	30	6.6	419	301
Health, education and leisure	11,526	381	129	3.3	34	1.1	8	75
Hotels and restaurants	6,079	211	107	3.5	51	1.8	13	116
Utilities	3,938	95	50	2.4	53	1.3	(20)	2
Other	18,818	740	399	3.9	54	2.1	68	587
Latent			400				(216)	
Total customers	327,478	10,310	4,455	3.1	43	1.4	537	3,695
Of which:								
UK								
Personal - mortgages	137,427	943	143	0.7	15	0.1	(4)	3
- unsecured	14,198	1,060	853	7.5	80	6.0	132	362
Property and construction	37,942	1,543	537	4.1	35	1.4	(98)	676
<i>of which: commercial real estate</i>	<i>25,311</i>	<i>1,323</i>	<i>426</i>	<i>5.2</i>	<i>32</i>	<i>1.7</i>	<i>(102)</i>	<i>600</i>
Other	115,833	3,133	1,299	2.7	41	1.1	666	629
Latent			318				(12)	
Total	305,400	6,679	3,150	2.2	47	1.0	684	1,670
Europe								
Personal - mortgages	15,548	3,144	872	20.2	28	5.6	226	287
- unsecured	265	52	46	19.6	88	17.4	5	11
Property and construction	1,055	85	84	8.1	99	8.0	(56)	933
<i>of which: commercial real estate</i>	<i>947</i>	<i>78</i>	<i>78</i>	<i>8.2</i>	<i>100</i>	<i>8.2</i>	<i>(83)</i>	<i>878</i>
Other	3,920	279	165	7.1	59	4.2	(156)	665
Latent			83				(204)	
Total	20,788	3,560	1,250	17.1	35	6.0	(185)	1,896

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Total banks 17,291

Note:

(1) Mortgages are reported in sectors other than personal mortgages by certain businesses based on the nature of the relationship with the customer.

Business review Capital and risk management

Past due analysis

The table below shows loans and advances to customers that were past due at the balance sheet date but are not considered impaired.

	2017	2016
	£m	£m
Past due 1-29 days	3,535	3,852
Past due 30-59 days	902	753
Past due 60-89 days	456	512
Past due 90 days or more	1,481	1,445
Total	6,374	6,562

Past due analysis by sector

Personal	3,731	3,577
Property and construction	667	1,020
Financial institution	24	94
Other corporate	1,952	1,871
Total	6,374	6,562

Risk elements in lending

The table below analyses REIL between UK and overseas, based on the location of the lending office.

	2017		2016	
	Impaired loans	Accruing past due	Impaired loans	Accruing past due
	£m	£m	£m	£m
UK	4,450	1,087	5,557	1,122
overseas	2,973	394	3,308	323
Total	7,423	1,481	8,865	1,445

Notes:

- (1) REIL are stated without giving effect to any security held that could reduce the eventual loss should it occur or to any provisions marked.
- (2) For details on impairment methodology refer to Credit risk on page 184 and Accounting policy 15 Impairment of financial assets on pages 246 and 247.

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Risk elements in lending

The tables below analyse REIL by segment.

	2017							Total £m	2016 Total £m
	UK PBB £m	Ulster Bank RoI £m	Commercial Banking £m	Private Banking £m	RBS International £m	NatWest Markets £m	Central items & other £m		
At 1 January*	2,372	3,513	1,946	105	109	2,264	1	10,310	12,157
Inter segment transfers			1,384			(1,384)			
Currency translation and other adjustments		123			5	(86)	1	43	1,013
Additions	1,227	550	1,590	28	62	98	14	3,569	5,306
Transfers between REIL and potential problem loans	(152)		10	(2)	7	8		(129)	(166)
Transfer to performing book	(294)	(336)	(283)		(33)	(12)	(1)	(959)	(960)
Repayments and disposals	(606)	(444)	(1,116)	(32)	(41)	(468)	(13)	(2,720)	(3,345)
Amounts written-off	(572)	(124)	(335)	(4)	(6)	(167)	(2)	(1,210)	(3,695)
At 31 December	1,975	3,282	3,196	95	103	253		8,904	10,310

* Re-presented to reflect segmental reorganisation

Business review Capital and risk management

Credit risk: balance sheet analysis [continued](#)

Provisions

The tables below analyse provisions by segment.

	2017							Total £m	2016 Total £m
	UK	Ulster Bank	Commercial	Private	RBS	NatWest	Central items		
	PBB £m	RoI £m	Banking £m	Banking £m	International £m	Markets £m	& other £m		
At 1 January*	1,537	1,200	845	31	38	803	1	4,455	7,139
Inter segment transfers			293			(293)			
Currency translation and other adjustments		8	(7)			(27)		(26)	480
Repayments and disposals						(5)		(5)	
Amounts written-off	(572)	(124)	(335)	(4)	(6)	(167)	(2)	(1,210)	(3,697)
Recoveries of amounts previously written-off	117	12	16		1	10		156	109
Charges/(releases) to income statement	235	60	362	6	3	(137)	1	530	537
Unwind of discount	(37)	(25)	(12)	(1)	(1)	(10)		(86)	(113)
At 31 December	1,280	1,131	1,162	32	35	174		3,814	4,455

* Re-presented to reflect segmental reorganisation

Securities and available-for-sale reserves

Debt securities

The table below analyses debt securities by issuer and IAS 39 classifications. The other financial institutions category includes US government sponsored agencies and securitisation entities, the latter principally relating to asset-backed securities (ABS). Ratings are based on the lowest of Standard & Poor's, Moody's and Fitch.

Central and local government UK	US	Other	Banks	Other financial institutions	Corporate	Total	Of which ABS
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2017	£m	£m	£m	£m	£m	£m	£m	£m
Held-for-trading (HFT)	3,514	3,667	14,736	1,844	2,746	974	27,481	870
Available-for-sale (AFS)	17,656	8,461	11,454	2,218	3,784	108	43,681	1,826
Loans and receivables (LAR)					3,501	142	3,643	3,500
Held-to-maturity (HTM)	4,128						4,128	
Total	25,298	12,128	26,190	4,062	10,031	1,224	78,933	6,196
Of which US agencies					333		333	
Short positions (HFT)	(3,490)	(2,501)	(20,390)	(584)	(1,361)	(200)	(28,526)	
<i>Ratings</i>								
AAA			9,130	2,502	6,354	27	18,013	4,320
AA to AA+	25,298	12,128	4,183	396	1,538	180	43,723	455
A to AA-			8,966	452	1,053	259	10,730	995
BBB- to A-			3,526	442	406	538	4,912	138
Non-investment grade			385	210	446	171	1,212	256
Unrated				60	234	49	343	32
Total	25,298	12,128	26,190	4,062	10,031	1,224	78,933	6,196
<i>Available-for-sale</i>								
AFS reserves (gross of tax)	108	44	119	6	125		402	11
Gross unrealised gains	703	67	324	8	24	1	1,127	12
Gross unrealised losses	(19)	(70)	(16)	(4)	(7)	(1)	(117)	
Of which:								
less than 12 months	(19)	(70)	(16)	(4)	(5)	(1)	(115)	
more than 12 months					(2)		(2)	

Business review Capital and risk management

Credit risk: balance sheet analysis continued

	Central and local government			Banks £m	Other financial institutions £m	Corporate £m	Total £m	Of which ABS £m
	UK £m	US £m	Other £m					
2016								
Held-for-trading (HFT)	2,615	4,133	14,087	821	2,299	549	24,504	886
Designated as at fair value (DFV)			25		2		27	
Available-for-sale (AFS)	10,581	6,953	15,678	1,852	4,072	118	39,254	2,263
Loans and receivables (LAR)					3,774	194	3,968	3,814
Held-to-maturity (HTM)	4,769						4,769	
Total	17,965	11,086	29,790	2,673	10,147	861	72,522	6,963
Of which US agencies					386		386	
Short positions (HFT)	(2,644)	(4,989)	(13,346)	(334)	(640)	(121)	(22,074)	
Ratings								
AAA			11,478	1,610	6,024	36	19,148	3,993
AA to AA+	17,965	11,086	5,533	481	720	34	35,819	244
A to AA-			9,727	238	2,128	150	12,243	1,627
BBB- to A-			2,737	155	698	378	3,968	645
Non-investment grade			315	69	458	31	873	381
Unrated				120	119	232	471	73
Total	17,965	11,086	29,790	2,673	10,147	861	72,522	6,963
Available-for-sale								
AFS reserves (gross of tax)	79	(66)	190	5	144	(6)	346	46
Gross unrealised gains	768	56	504	8	93	2	1,431	75
Gross unrealised losses	(16)	(123)	(13)	(1)	(43)	(2)	(198)	(32)
Of which:								
less than 12 months	(16)	(123)	(13)	(1)	(11)	(2)	(166)	(1)
more than 12 months					(32)		(32)	(31)

Key points

- HFT assets and short positions: UK government securities, as well as European and Japanese government bonds, increased in 2017 driven by client flow trading and market making activity in NatWest Markets. US government securities were down, both assets and short positions, compared with 2016 due to lower client demand towards the end of 2017.
- AFS assets: The increase in 2017, largely within UK government securities, was due to the liquidity portfolio management, as gilts offered higher capital adjustment returns relative to central bank cash balances.

Business review Capital and risk management

Credit risk: balance sheet analysis *continued*

Asset-backed securities

The table below summarises the ratings of asset-backed securities on the balance sheet.

	Prime £m	RMBS (1) Non- conforming £m	Sub-prime £m	CMBS (1) £m	CDOs & CLOs £m	Other ABS £m	Total £m
2017							
AAA	1,255				75	2,990	4,320
AA to AA+	408				19	28	455
A to AA-	500	1		36	55	403	995
BBB- to A-	83			4	27	24	138
Non-investment grade (2)	159	1		4	52	40	256
Unrated (3)	5				8	19	32
Total	2,410	2		44	236	3,504	6,196
2016							
AAA	654				23	3,316	3,993
AA to AA+	52	155			3	34	244
A to AA-	460	2		22	33	1,110	1,627
BBB- to A-	84			470	21	70	645
Non-investment grade (2)	182	1	8	15	121	54	381
Unrated (3)	5				19	49	73
Total	1,437	158	8	507	220	4,633	6,963

Notes:

(1) Residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) are securities that represent an interest in a portfolio of residential and commercial mortgages respectively. Repayments made on the underlying mortgages are used to make payments to holders of the mortgage-backed securities (MBS). The risk of the MBS will vary primarily depending on the quality and geographic region in which the underlying mortgage assets are located and the credit enhancement of the securitisation structure. Several tranches of notes are issued, each secured against the same portfolio of mortgages, but providing differing levels of seniority to match the risk appetite of investors. The most junior (or equity) notes will suffer early capital and interest losses experienced by the referenced mortgage collateral, with each more senior note benefiting from the protection provided by the subordinated notes below. Additional credit enhancements may be provided to the holder of senior MBS notes.

The main categories of mortgages that serve as collateral to RMBS held by RBS are set out below and described in the Glossary on page 409. The US market has more established definitions of differing underlying mortgage quality and these are used as the basis for RBS's RMBS categorisation.

(2) Comprises HFT £256 million (2016 - £282 million), AFS nil (2016 - £99 million) and LAR nil (2016 - nil).

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(3) Comprises HFT £14 million (2016 - £25 million), AFS nil (2016 - nil) and LAR £18 million (2016 - £48 million).

Equity shares

The table below analyses holdings of equity shares for eurozone countries and other countries with balances of more than £50 million by country, issuer and IAS 39 classification. The HFT positions are used mainly for economic hedging of debt issuances and equity derivatives. The AFS balances are individually small holdings in unlisted companies, mainly acquired through debt for equity transactions in Restructuring.

Countries	HFT				AFS/DFV (1)				Total reserves £m	
	Banks £m	Other financial institutions (2) £m	Corporate £m	Total HFT £m	Banks £m	Other financial institutions (2) £m	Corporate £m	Total AFS/DFV £m		
2017										
Netherlands						39	84	123	123	2
Other		1	4	5		11		11	16	2
Total eurozone		1	4	5		50	84	134	139	4
UK	1	4	19	24	3	123	13	139	163	(63)
US						126	2	128	128	38
Other						17	3	20	20	3
Total	1	5	23	29	3	316	102	421	450	(18)
2016										
Total	10	132	24	166		460	77	537	703	19

Notes:

(1) Designated as at fair value through profit or loss balances are £134 million (2016 - £171 million), of which £47 million are other financial institutions (2016 - £142 million) and £87 million are corporate (2016 - £29 million).

(2) Includes government sponsored entities.

(3) HFT short positions of £1 million (2016 - £3 million) did not relate to non-periphery eurozone countries.

Business review Capital and risk management

Credit risk: balance sheet analysis continued

Derivatives

Summary and net uncollateralised exposures

The table below analyses derivatives by type of contract. The master netting agreements and collateral shown below do not result in a net presentation on the balance sheet under IFRS.

	2017					2016				
	GBP £bn	USD £bn	Notional Euro £bn	Other £bn	Total £bn	Assets £m	Liabilities £m	Notional £bn	Assets £m	Liabilities £m
Interest rate	2,512	4,311	4,317	876	12,016	120,945	112,160	16,625	170,524	158,485
Exchange rate	352	1,598	579	896	3,425	39,211	41,681	4,445	75,442	77,148
Credit		9	29		38	531	558	42	682	557
Equity and commodity		2	1		3	156	107	21	333	285
Balance sheet	2,864	5,920	4,926	1,772	15,482	160,843	154,506	21,133	246,981	236,475
Counterparty mark-to-market netting						(128,287)	(128,287)		(197,288)	(197,288)
Cash collateral						(20,311)	(18,035)		(28,742)	(20,417)
Securities collateral						(5,850)	(3,952)		(8,435)	(11,048)
Net exposure						6,395	4,232		12,516	7,722
Banks (1)						461	466		1,260	1,339
Other financial institutions (2)						1,608	1,625		3,090	2,897
Corporate (3)						3,843	2,065		7,348	3,393
Government (4)						483	76		818	93
Net exposure						6,395	4,232		12,516	7,722
UK						4,079	1,853		7,065	3,009
Europe						1,643	1,777		3,466	3,215
US						346	317		930	673
RoW						327	285		1,055	825
Net exposure						6,395	4,232		12,516	7,722

	2017 £m	2016 £m
Asset quality of uncollateralised derivative assets		
AQ1 - AQ4	5,173	9,775
AQ5 - AQ8	1,216	2,724
AQ9	3	4
AQ10	3	13

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Net exposure	6,395	12,516
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Notes:

- (1) Transactions with certain counterparties with whom RBS has netting arrangements but collateral is not posted on a daily basis; certain transactions with specific terms that may not fall within netting and collateral arrangements; derivative positions in certain jurisdictions for example China where the collateral agreements are not deemed to be legally enforceable.
- (2) Transactions with securitisation vehicles and funds where collateral posting is contingent on RBS's external rating.
- (3) Predominantly large corporate with whom RBS may have netting arrangements in place, but operational capability does not support collateral posting.
- (4) Sovereigns and supranational entities with one way collateral agreements in their favour.
- (5) The notional amount of interest rate derivatives include £7,400 billion (2016 - £9,724 billion) in respect of contracts cleared through central clearing counterparties. The associated derivatives assets and liabilities including variation margin reflect IFRS offset of £17 billion (2016 - £51 billion) and £17 billion (2016 - £51 billion) respectively.

Key points

- Interest rate derivative fair values decreased, reflecting the upward shift in yields of US dollar, sterling and euro during 2017, as well as trade compression and novations to clearing houses.
- The decrease in foreign exchange derivative fair values reflected US dollar depreciation against major currencies in 2017.
- Derivative notionals decreased by 27%, mainly due to trade compression cycle participation, maturities and buyouts, as well as the effect of foreign exchange. This was offset by new business.
- Net asset and liability exposures both decreased in line with the overall reduction in fair values. The corporate sector reductions largely reflected disposal activity in legacy NatWest Markets. The other financial sector reduction was partially due to timing of collateral posting.

Business review Capital and risk management

Credit risk: balance sheet analysis [continued](#)

Valuation reserves

When valuing financial instruments in the trading book, adjustments are made to mid-market valuations to cover bid-offer spread, liquidity and credit risk. The following table shows credit valuation adjustments (CVA) and other valuation reserves. CVA represents an estimate of the adjustment to fair value that a market participant would make to incorporate the risk inherent in derivative exposures. For details of CVA methodology, refer to Note 9 on the consolidated accounts: Financial instruments - valuation.

	2017 £m	2016 £m
Funding valuation adjustments (FVA)	440	936
Credit valuation adjustments (CVA)	346	618
Bid-offer reserves	285	334
Product and deal specific	1,033	643
Valuation reserves	2,104	2,531

The table below analyses CVA relating to counterparties by rating and sector.

	2017 £m	2016 £m
Ratings		
AAA	4	4
AA to AA+	11	22
A to AA-	34	52
BBB- to A-	203	388
Non-investment grade and unrated	94	152
	346	618
Counterparty		
Banks	8	22
Other financial institutions	31	70
Corporate	200	337
Government	107	189
	346	618

Key points

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- Both FVA and CVA were lower due to trade novations and market movements in 2017.
- Reduced funding levels and an increase in the level of funding costs included within the discount rate applied to derivative cash flows also contributed to the FVA reduction.
- Credit spread tightening also contributed to the CVA reduction.
- The product and deal specific reserves increased primarily on a limited number of uncollateralised derivatives after the pricing impact of a significant novation in the second half of 2017 was incorporated into transactions of a similar nature.

Derivatives: settlement basis and central counterparties

The table below analyses the derivative notional and fair value by trading and settlement method.

	Notional			Total	Asset		Liability	
	Traded on	Traded over the counter	Not settled		Traded on	Traded	Traded on	Traded
	recognised	Settled by	by central	recognised	over the	recognised	over the	
	exchanges	central	counterparties	exchanges	counter	exchanges	counter	
	£bn	£bn	£bn	£bn	£m	£m	£m	
2017								
Interest rate	1,506	7,400	3,110	12,016	-	120,945	-	112,160
Exchange rate	4		3,421	3,425	-	39,211	-	41,681
Credit			38	38	-	531	-	558
Equity and commodity			3	3	-	156	1	106
Total	1,510	7,400	6,572	15,482	-	160,843	1	154,505
2016								
Interest rate	1,501	9,724	5,400	16,625		170,524		158,485
Exchange rate	2		4,443	4,445		75,442		77,148
Credit			42	42		682		557
Equity and commodity	1		20	21		333	4	281
Total	1,504	9,724	9,905	21,133		246,981	4	236,471

Business review **Capital and risk management**

Market risk

RBS is exposed to non-traded market risk as a result of its banking activities and to traded market risk through its trading activities. It manages its non-traded and traded market risk exposures separately. Each type of market risk is discussed separately. The non-traded market risk section begins below. The traded market risk section begins on page 216.

Pension-related activities also give rise to market risk. Refer to page 222 for more information on risk related to pensions.

Non-traded market risk

The following disclosures in this section are audited:

- Internal banking book VaR.
- Foreign exchange risk.
- Equity risk.

Definition

Non-traded market risk is the risk to the value of assets or liabilities outside the trading book, or the risk to income, that arises from changes in market prices such as interest rates, foreign exchange rates and equity prices, or from changes in managed rates.

Key developments in 2017 (unaudited)

- During 2017, revised non-traded market risk appetite metrics were approved by the Board and cascaded to the franchises.
- Political events during the year, notably elections in the UK, France and the Netherlands, resulted in periods of market volatility. UK and European interest rates remained at low levels, although the Bank of England and the US Federal Reserve began raising interest rates. These events did not affect non-traded market risk management strategy during the year.
- Non-traded market risk VaR peaked at £83.1 million in H1 2017, mainly driven by an increase in bonds held within Treasury's liquidity portfolio, which was aimed at investing surplus cash, rather than meeting increased liquidity requirements. The appreciation of foreign currency bonds within this portfolio, primarily US and German sovereign debt, also contributed. The target allocation between cash and bonds, which is determined by the cash requirement of the liquid asset buffer, was reached in H1 2017 and remained largely unchanged during H2 2017.

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- Positive sensitivity to higher interest rates increased by £275 million year on year in a 100-basis-point upward rate shift, partly due to higher deposit volumes and changes in assumptions relating to deposit margin retention in a higher rate environment. Adverse sensitivity to lower rates also increased, by £193 million in a 100-basis-point downward shift, affected by the higher level of interest rates in the central forecast.
- RBS continued to invest in structural hedges in 2017, with an average notional of £129 billion, managed directly by Treasury. The disclosure now also shows the smaller structural hedging programmes in Private Banking, RBS International, UBI DAC and Ulster Bank Limited totalling an average of £20 billion in 2017.

Sources of risk (unaudited)

The majority of RBS's non-traded market risk exposure arises from retail and commercial banking activities from assets and liabilities that are not classified as held-for-trading.

Non-traded market risk is largely managed in line with the following key categories: interest rate risk; credit spread risk; foreign exchange risk; equity risk; and accounting volatility risk.

Interest rate risk

Non-traded interest rate risk (NTIRR) arises from the provision to customers of a range of banking products that have differing interest rate characteristics. When aggregated, these products form portfolios of assets and liabilities with varying degrees of sensitivity to changes in market interest rates. Mismatches in these characteristics can give rise to volatility in net interest income as interest rates vary.

NTIRR comprises three primary risk factors: gap risk, basis risk and option risk. For more information, refer to page 209.

Credit spread risk

Credit spread risk arises from the potential adverse economic impact of a move in the spread between bond yields and swap rates, where the bond portfolios are accounted at fair value through equity.

Foreign exchange risk

Non-traded foreign exchange risk exposures arise from two main sources:

- **Structural foreign exchange risk** arising from the capital deployed in foreign subsidiaries, branches and joint arrangements and related currency funding where it differs from sterling.
- **Non-trading book foreign exchange risk** arising from customer transactions and profits and losses that are in a currency other than the functional currency of the transacting operation.

Equity risk

Non-traded equity risk is the potential variation in income and reserves arising from changes in the values of equity positions. Equity exposures may arise through strategic acquisitions, venture capital investments and certain restructuring arrangements.

Accounting volatility risk

Accounting volatility risk arises when an exposure is accounted for at amortised cost but economically hedged by a derivative that is accounted for at fair value. Although this is not an economic risk, the difference in accounting between the exposure and the hedge creates volatility in the income statement.

Business review **Capital and risk management**

Non-traded market risk *continued*

Risk governance (unaudited)

Responsibility for identifying, measuring, monitoring and controlling the market risk arising from non-trading activities lies with the relevant business, with second-line-of-defence oversight provided by the Non-Traded Market Risk function, which reports into the Director of Enterprise Wide Risk.

Risk positions are reported monthly to the Executive Risk Forum (ERF) and quarterly to the Board Risk Committee, as well as to the Asset and Liability Committee (ALCo) (monthly in the case of interest rate, credit spread and accounting volatility risks and quarterly in the case of foreign exchange and equity risks).

Market risk policy statements set out the governance and risk management framework through effective identification, measurement, reporting, mitigation, monitoring and control.

Risk appetite (unaudited)

RBS's qualitative appetite is set out in the non-traded market risk appetite statement.

Its quantitative appetite is expressed in terms of exposure limits. These limits comprise both Board risk measures (which are approved by the RBS Board on the recommendation of the Board Risk Committee) and key risk measures (which are approved by the ALCo).

These limits are cascaded further down the organisation as required, as approved by the Technical Executive Risk Forum in the case of the Board risk measures and by the ALCo in the case of the key risk measures.

The limit framework at RBS level comprises value-at-risk (VaR), stressed value-at-risk (SVaR), sensitivity and stress limits, and earnings-at-risk limits.

The limits are reviewed to reflect changes in risk appetite, business plans, portfolio composition and the market and economic environments.

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To ensure approved limits are not breached and that RBS remains within its risk appetite, triggers at RBS and lower levels have been set such that if exposures exceed a specified level, action plans are developed by the front office, Market Risk and Finance.

For further information on risk appetite, refer to page 156.

Risk controls and assurance (unaudited)

For information on risk controls and assurance, refer to page 158.

Risk assessment, monitoring and mitigation (unaudited)

Interest rate risk

Non-traded interest rate risk (NTIRR) factors are grouped into the following categories:

- **Gap risk** which arises from the timing of rate changes in non-trading book instruments. The extent of gap risk depends on whether changes to the term structure of interest rates occur consistently across the yield curve (parallel risk) or differentially by period (non-parallel risk).
- **Basis risk** which captures the impact of relative changes in interest rates for financial instruments that have similar tenors but are priced using different interest rate indices, or on the same interest rate indices but with different tenors.
- **Option risk** which arises from option derivative positions or from optional elements embedded in assets, liabilities and/or off-balance sheet items, where RBS or its customer can alter the level and timing of their cash flows. Option risk can be further characterised into automatic option risk and behavioural option risk. One example of behavioural option risk is pipeline risk. This is the risk of loss arising from personal customers owning an option to draw down a loan (typically a mortgage loan) at a committed rate. Changes in interest rates can result in greater or fewer customers than anticipated taking up the committed offer. The risk depends on customer behaviour as the option will not automatically be exercised.

Due to the long-term nature of many retail and commercial portfolios and their varied interest rate repricing characteristics and maturities, it is likely that net interest income will vary from period to period, even if interest rates remain the same. New business originated in any period will alter RBS's interest rate sensitivity if the resulting portfolio differs from portfolios originated in prior periods, depending on the extent to which exposure has been hedged.

In order to manage exposures within these limits, RBS aggregates its interest rate positions and hedges them externally using cash and derivatives, primarily interest rate swaps.

This task is primarily carried out by RBS Treasury, to which all businesses except NatWest Markets transfer most of their NTIRR. The main exposures and limit utilisations are reported to the ALCo and the ERF monthly and to the Board Risk Committee quarterly.

Credit spread risk

The bond portfolios primarily comprise high-quality securities that are maintained as a liquidity buffer to ensure RBS can continue to meet its obligations in the event that access to wholesale funding markets is restricted.

Additionally other high-quality bond portfolios are held for collateral purposes and to support payment systems.

Credit spread risk is monitored daily through sensitivities and VaR measures. The dealing authorities in place for the bond portfolios further mitigate the risk by imposing constraints by duration, asset class and credit rating. Exposures and limit utilisations are reported to senior management on a daily basis as well as to the ERF monthly and the Board Risk Committee quarterly.

Business review **Capital and risk management**

Non-traded market risk *continued*

Foreign exchange risk

The only material non-traded open currency positions are the structural foreign exchange exposures arising from investments in foreign subsidiaries, branches and associates and their related currency funding. These exposures are assessed and managed by RBS Treasury to predefined risk appetite levels under delegated authority from the ALCo. Treasury seeks to limit the potential volatility impact on RBS's Common Equity Tier 1 (CET1) ratio from exchange rate movements by maintaining a structural open currency position. Gains or losses arising from the retranslation of net investments in overseas operations are recognised in equity reserves and reduce the sensitivity of capital ratios to foreign exchange rate movements primarily arising from the retranslation of non-sterling-denominated RWAs. Sensitivity is minimised where, for a given currency, the ratio of the structural open position to RWAs equals the CET1 ratio.

The sensitivity of this ratio to exchange rates is monitored monthly and reported to the ALCo at least quarterly. Foreign exchange exposures arising from customer transactions are sold down by businesses on a regular basis in line with RBS policy.

Equity risk

Non-traded equity risk is the potential variation in the income and reserves arising from changes in equity valuations. Any such risk is identified prior to any investments and then mitigated through a framework of controls.

Investments, acquisitions or disposals of a strategic nature are referred to RBS's Acquisitions and Disposals Committee (ADCo). Once approved by ADCo for execution, such transactions are referred for approval to the Board, the Executive Committee, the Chief Executive, the Chief Financial Officer or as otherwise required. Decisions to acquire or hold equity positions in the non-trading book that are not of a strategic nature, such as customer restructurings, are taken by authorised persons with delegated authority under the credit approval framework.

Accounting volatility risk

Accounting volatility can be mitigated through hedge accounting. The profit and loss impact of the derivatives can be mitigated by marking the exposure to market. However, volatility will remain in cases where accounting rules mean that hedge accounting is not an option. Accounting volatility is reported to the ALCo monthly and capitalised as part of the Internal Capital Adequacy Assessment Process.

Risk measurement

The market risk exposures that arise as a result of RBS's retail and commercial banking activities are measured using a combination of value-based metrics (VaR and sensitivities) and earnings-based metrics, as explained in greater detail for each of the key non-traded risk exposure types disclosed in this section.

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The following table presents 1-day internal banking book VaR at a 99% confidence level, analysed by type of risk.

	2017				2016			
	Average £m	Maximum £m	Minimum £m	Period end £m	Average £m	Maximum £m	Minimum £m	Period end £m
Interest rate	9.1	15.3	5.6	5.6	9.6	19.3	4.7	18.0
Euro	3.3	4.3	2.3	3.3	3.0	3.8	2.1	3.8
Sterling	6.3	13.8	1.8	2.8	10.2	23.7	4.8	20.6
US dollar	5.5	8.8	2.1	7.7	2.9	4.7	1.6	2.1
Other	1.0	1.1	0.8	0.8	1.7	2.4	1.1	1.1
Credit spread	60.6	82.4	47.4	49.7	57.2	66.6	41.6	62.9
Structural foreign exchange rate	12.4	17.2	9.3	15.4	13.4	19.6	10.5	10.5
Pipeline risk	0.9	1.7	0.2	1.0	0.6	1.2	0.2	0.5
Diversification (1)	(19.2)			(17.3)	(23.7)			(20.2)
Total	63.8	83.1	54.4	54.4	57.1	71.7	41.5	71.7

Note:

(1) RBS benefits from diversification across various financial instrument types, currencies and markets. The extent of the diversification benefit depends on the correlation between the assets and risk factors in the portfolio at a particular time. The diversification factor is the sum of the VaR on individual risk types less the total portfolio VaR.

Key points

- On an average basis, total non-traded VaR increased during 2017, chiefly due to the increase in bonds held within Treasury's liquidity portfolio, which was aimed at investing surplus cash, whilst the duration and quality of the assets remained largely unchanged. The increased investment in bonds increased the valuation sensitivity to movements between bond and swap rates as the bond portfolios are hedged with interest rate swaps.
- On a period-end basis, total non-traded VaR decreased, driven by credit spread VaR, which fell due to refinements in the source of the market data used for the VaR model. One of the largest loss dates dropped out of the historical time series for VaR during Q3 2017, which also contributed to the decline.
- The increase in structural foreign exchange rate VaR towards the end of the year reflected higher euro-denominated investments in subsidiaries, which are expected to decline following a dividend paid by UBI DAC in January 2018.
- The year-on-year decline in sterling interest rate VaR, on both a period-end and average basis, partly reflects the impact of charges to equity recognised at year-end 2016 on RBS's structural hedge benchmark. The charges to equity related mainly to increased provisions against prospective RMBS fines. The equity structural hedge was reduced in 2016 and 2017. For more information on structural hedging, refer to the following page.

Business review Capital and risk management

Non-traded market risk *continued*

Structural hedging (unaudited)

RBS has the benefit of a significant pool of stable, non and low interest-bearing liabilities, principally comprising equity and money transmission accounts. These balances are usually hedged, either by investing directly in longer-term fixed-rate assets or by the use of interest rate swaps, in order to provide a consistent and predictable revenue stream.

After hedging the net interest rate exposure of the bank externally, RBS Treasury allocates income to products or equity in structural hedges by reference to the relevant interest rate swap curve. Over time, the hedging programme has built up a portfolio of interest rate swaps that provide a basis for stable income attribution. The programme aims to track a time series of medium-term swap rates, but the yield will be affected by changes in product volumes and RBS's capital composition.

The table below presents the incremental income allocation (above 3-month LIBOR), the average notional and the overall yield (including 3-month LIBOR) associated with the product and equity hedges managed by Treasury.

	Incremental income £m	2017 Average notional £bn	Overall yield %	Incremental income £m	2016 Average notional £bn	Overall yield %
Equity structural hedging	628	28	2.48%	633	33	2.41%
Product structural hedging	680	101	1.02%	635	90	1.20%
Total	1,308	129	1.34%	1,268	123	1.47%

The table below presents the incremental income associated with product structural hedges at segment level. These relate to the main banking businesses except Private Banking, RBS International, UBI DAC and Ulster Bank Limited.

Net interest income - impact of product structural hedging (unaudited)	2017 £m	2016* £m
UK Personal & Business Banking	440	390
Commercial Banking	235	235
Other	5	10
Total	680	635

* Re-presented to reflect the segmental reorganisation.

Key points (unaudited)

- The overall yield (including 3-month LIBOR) fell compared to 31 December 2016, reflecting the lower volume of equity hedges, new product hedges and maturing hedges reinvested at lower market rates.
- The fall in the average notional of the equity hedge reflects the reduction in RBS's equity base.
- The increase in the average notional of the product hedge reflected growth in current account and deposit balances and increased hedging to reduce earnings sensitivity.
- As at 31 December 2017, the 10-year and 5-year swap rates were 1.21% and 0.98%, respectively. The market rate matching the amortising structure of the total structural hedge was 0.92%.

In addition to the hedges presented in the table above, other parts of the Group also maintain structural hedges. Hedges are transacted with Treasury and generally have an amortised five-year profile. In aggregate, Private Banking, RBS International, UBI DAC and Ulster Bank Limited maintained structural hedges against Treasury relating to equity and products, with an average notional of £20 billion for 2017. This resulted in £147 million incremental income allocation (above 3-month LIBOR) to the businesses in 2017, with an overall yield of 0.83%. A significant proportion of the hedge is euro-denominated.

Business review **Capital and risk management**

Non-traded market risk *continued*

Interest rate risk (unaudited)

NTIRR can be measured from either an economic value-based or earnings-based perspective, or a combination of the two. Value-based approaches measure the change in value of the balance sheet assets and liabilities over a longer timeframe, including all cash flows. Earnings-based approaches measure the potential short-term (generally one-year) impact on the income statement of changes in interest rates.

RBS uses both approaches to quantify its interest rate risk: VaR as its value-based approach and sensitivity of net interest income (NII) as its earnings-based approach.

These two approaches provide different yet complementary views of the impact of interest rate risk on the balance sheet at a point in time. The scenarios employed in the NII sensitivity approach incorporate business assumptions and simulated modifications in customer behaviour as interest rates change. In contrast, the VaR approach assumes static underlying positions and therefore does not provide a dynamic measurement of interest rate risk. In addition, while the NII sensitivity calculations are measured to a 12-month horizon and thus provide a shorter-term view of the risks on the balance sheet, the VaR approach can identify risks not captured in the sensitivity analysis, in particular the impact of duration and repricing risk on earnings beyond 12 months.

Value-at-risk (unaudited)

VaR is a statistical estimate of the potential change in the market value of a portfolio (and, thus, the impact on the income statement) over a specified time horizon at a given confidence level.

RBS's standard VaR metrics - which assume a time horizon of one trading day and a confidence level of 99% - are based on interest rate repricing gaps at the reporting date. Daily rate moves are modelled using observations over the last 500 business days. These incorporate customer products plus associated funding and hedging transactions as well as non-financial assets and liabilities such as property, plant and equipment, capital and reserves. Behavioural assumptions are applied as appropriate.

The non-traded interest rate risk VaR metrics for RBS's retail and commercial banking activities are included within the banking book VaR table above. The VaR captures the risk resulting from mismatches in the repricing dates of assets and liabilities.

It includes any mismatch between structural hedges and stable non and low interest-bearing liabilities such as equity and money transmission accounts as regards their interest rate repricing behavioural profile.

Sensitivity of net interest income (unaudited)

Earnings sensitivity to rate movements is derived from a central forecast over a 12-month period. A simplified scenario is shown based on the period-end balance sheet assuming that non-interest rate variables remain constant. Market-implied forward rates are used to generate a base-case earnings forecast, which is then subjected to interest rate shocks. The variance between the central forecast and the shock gives an indication of underlying sensitivity to interest rate movements.

The sensitivity of net interest income table below shows the expected impact, over the next 12 months, to an immediate upward or downward change of 25 and 100 basis points to all interest rates. All yield curves are expected to move in parallel with the exception that interest rates are assumed to floor at zero per cent or, for euro rates, at the current negative rate.

The main driver of earnings sensitivity relates to interest rate pass-through assumptions on customer products. The scenario also captures the impact of the reinvestment of maturing structural hedges at higher or lower rates than the base-case earnings sensitivity and mismatches in the repricing dates of loans and deposits.

However, reported sensitivities should not be considered predictive of future performance. They do not capture potential management action in response to sudden changes in the interest rate environment. Actions that could reduce the net interest income sensitivity and mitigate adverse impacts are changes in pricing strategies on both customer loans and deposits as well as hedging. Management action may also be targeted at stabilising total income taking into account non-interest income in addition to net interest income.

Business review Capital and risk management

Non-traded market risk *continued*

	Euro £m	Sterling £m	US dollar £m	Other £m	Total £m
2017					
+ 25 basis point shift in yield curves	13	151	14		178
25 basis point shift in yield curves	(8)	(218)	(13)	(4)	(243)
+ 100 basis point shift in yield curves	53	664	58		775
100 basis point shift in yield curves	(11)	(504)	(49)	(7)	(571)
2016					
+ 25 basis point shift in yield curves	4	79	11	2	96
25 basis point shift in yield curves	(1)	(222)	(11)	(2)	(236)
+ 100 basis point shift in yield curves	9	436	42	13	500
100 basis point shift in yield curves	(2)	(337)	(30)	(9)	(378)

Note:

- (1) In the 25 and 100 basis point downward shifts in yield curves, interest rates are floored at zero per cent, or at current negative rates.

The table above focused solely on the projected sensitivity of net interest income over the next 12 months. In the case of multi-year forward projections, the negative impact of a downward change in rates or, conversely, the benefit of an immediate upward change in interest rates to current market rates would be greater. This is because, over time a greater proportion of maturing structural hedges will be reinvested at prevailing rates which may be higher or lower. Also, in the absence of dynamic assumptions relating to further management actions, the variance to the base-case income forecast arising from margin compression or expansion on managed rate products will continue to accrue.

The tables below show the net interest earnings sensitivity on a one-year, two-year and three-year forward-looking basis to a parallel upward or downward shift in interest rates of 25 basis points. The projection is a simplified sensitivity in which the balance sheet is assumed to be constant, with no change in customer behaviour or margin management strategy as a result of changes to the rates on offer.

The benefit of structural hedges increases (or decreases) as greater volumes of maturing hedges are reinvested at higher (or lower) rates over the three-year period.

Change in net interest earnings 25 basis point upward shift in yield curves

	Year 1 £m	Year 2 (2) £m	Year 3 (2) £m
2017			
Structural hedges	33	100	171
Managed margin (1)	153	170	178
Other	(8)		
Total	178	270	349

Change in net interest earnings 25 basis point downward shift in yield curves

2017	Year 1	Year 2 (2)	Year 3 (2)
	£m	£m	£m
Structural hedges	(33)	(99)	(171)
Managed margin (1)	(220)	(137)	(121)
Other	10		
Total	(243)	(236)	(292)

Notes:

- (1) Primarily current accounts and savings accounts.
- (2) The projections for Years 2 and 3 consider only the main drivers of earnings sensitivity, namely structural hedging and margin management.

Key points (unaudited)

- Earnings sensitivity to 25 and 100 basis-point upward shifts in yield curves increased year on year, partly due to higher deposit volumes. Additionally, more benefit from higher rates was assumed to result from margin management in 2017 than in 2016.
- Sensitivity to a 100 basis-point downward shift in yield curves rose year on year, partly affected by the higher level of future interest rates in the central forecast. Interest rates fall further in a 100 basis-point downward shift in yield curves before they hit an assumed zero per cent floor; as customer deposit rates are less affected by the scenario, profit margins compress.

Business review Capital and risk management

Non-traded market risk *continued*

Sensitivity of available-for-sale and cash flow hedging reserves to interest rate movements (unaudited)

While the projected sensitivity of net interest income is favourable to an upward shift in the yield curve and adversely sensitive to a downward shift in the yield curve, the market valuation sensitivity of derivatives hedging retail and commercial structural interest rate exposures is adversely sensitive to an upward shift in the yield curve and favourable to a downward shift in the yield curve. Many of the derivatives are documented in cash flow hedge accounting relationships because they reduce the sensitivity of expected future cash flows to unexpected changes in interest rates. If the derivative hedges are maintained to maturity, the immediate impact on the portfolio value would lessen over time as derivative cash flows are settled (amongst other potential factors).

The information shown below comprises simplified scenarios in which all rates across the yield curve have instantaneously shifted upwards or downwards by 25 basis points and 100 basis points and taxation effects have not been estimated. In this analysis, interest rates have not been floored at zero. Note that a movement in the AFS reserve would have an impact on CET1 capital but a movement in the cash flow hedge reserve would not be expected to do so. Volatility in both reserves affects tangible net asset value.

	Available-for-sale reserve £m	Cashflow hedge reserve £m	Total £m
2017			
+ 25 basis points	(41)	(443)	(484)
25 basis points	42	448	490
+ 100 basis points	(164)	(1,744)	(1,908)
100 basis points	167	1,819	1,986
2016			
+ 25 basis points	(36)	(417)	(453)
25 basis points	35	422	457
+ 100 basis points	(150)	(1,641)	(1,791)
100 basis points	135	1,714	1,849

Key point (unaudited)

- The sensitivity of the available-for-sale reserve and the cash flow hedge reserve to upward and downward shifts in yield curves remain relatively stable year on year. The increase in sensitivity of the available-for-sale reserve reflected the increase in bonds held within Treasury's liquidity portfolios.

Foreign exchange risk

The table below shows structural foreign currency exposures.

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	Net investments in foreign operations	Non-controlling interests (NCI) excluding NCI (1)	Net investments in foreign operations	Net Structural foreign investment	Structural foreign currency exposures pre-economic hedges	Economic foreign currency hedges (2)	Residual structural foreign currency exposures
	£m	£m	£m	£m	£m	£m	£m
2017							
US dollar	766		766	(14)	752	(752)	
Euro	7,160	61	7,099	(342)	6,757	(2,224)	4,533
Other non-sterling	2,493	645	1,848	(930)	918	(453)	465
Total	10,419	706	9,713	(1,286)	8,427	(3,429)	4,998
2016							
US dollar	(595)		(595)	(28)	(623)		(623)
Euro	6,085	(4)	6,089	(582)	5,507	(2,289)	3,218
Other non-sterling	3,366	761	2,605	(1,491)	1,114	(625)	489
Total	8,856	757	8,099	(2,101)	5,998	(2,914)	3,084

Notes:

(1) Non-controlling interests (NCI) represents the structural foreign exchange exposure not attributable to owners' equity.

(2) Economic hedges mainly represent US dollar and euro preference shares in issue that are treated as equity under IFRS and do not qualify as hedges for accounting purposes. They provide an offset to structural foreign exchange exposures to the extent that there are net assets in overseas operations available.

Business review **Capital and risk management**

Non-traded market risk *continued*

Key points (unaudited)

- The increase in net investments in foreign operations mainly reflected investment taken to support RBS's business in the US. Net investments in euro-denominated operations also increased in 2017. However, a dividend paid by UBI DAC in January 2018 has reduced net investments in euro operations by approximately £1.3 billion.
- The reduction in net investment hedges mainly reflected the reduction in hedges of other non-sterling investments in foreign operations. Hedges are reduced as a result of the reduction in net investments in other non-sterling foreign operations due to disposals, dividends or other capital repatriations.
- Changes in foreign currency exchange rates affect equity in proportion to structural foreign currency exposure. For example, a 5% strengthening or weakening in foreign currencies against sterling would respectively result in a gain or loss of £0.4 billion in equity (2016 a 5% strengthening or weakening in foreign currencies against sterling would respectively have resulted in a gain or loss of £0.3 billion).

Equity risk

Equity positions are carried at fair value on the balance sheet based on available market prices where possible. In the event that market prices are not available, fair value is based on appropriate valuation techniques or management estimates.

The table below shows the balance sheet carrying value of non-traded book equity positions.

	2017	2016
	£m	£m
Exchange-traded equity	41	33
Private equity	243	357
Other	136	146
	420	536

The exposures may take the form of (i) equity shares listed on a recognised exchange, (ii) private equity shares defined as unlisted equity shares with no observable market parameters or (iii) other unlisted equity shares.

	2017	2016
	£m	£m
Net realised gains arising from disposals	82	295
Unrealised gains included in Tier 1 or Tier 2 capital	60	53

Note:

- (1) Includes gains or losses on available-for-sale instruments only.

Key point

- The reduction in equity shareholdings mainly reflected disposals of equity stakes in private equity and other equity investments.

Calculation of regulatory capital (unaudited)

Non-traded market risk exposures are capitalised through the Internal Capital Adequacy Assessment Process (ICAAP). This process covers the following risk types: gap risk, basis risk, credit spread risk, pipeline risk, structural foreign exchange risk, prepayment risk and accounting volatility risk. ICAAP is performed using a combination of value-based and earnings-based measures.

The total non-traded market risk capital requirement is determined by adding the different charges for each sub risk type. The ICAAP methodology captures at least ten years of historical volatility and is produced to a 99% confidence level. Methodologies are reviewed by Model Risk Management and results are approved by the Capital Management and Stress Testing Committee.

Business review **Capital and risk management**

Traded market risk

The following disclosures in this section are audited:

- Internal VaR

Definition

Within trading books, traded market risk is the risk arising from changes in fair value on positions, assets, liabilities or commitments as a result of fluctuations in market prices.

Key developments in 2017 (unaudited)

- During H1 2017, revised traded market risk appetite metrics were approved by the Board and cascaded to the franchises. In Q4 2017, the limits for NatWest Markets were revised to accommodate trading book positions from the legacy portfolio which has now been re-integrated into NatWest Markets.
- Political events during the year, including elections in the UK, France and the Netherlands, resulted in periods of market volatility. European interest rates remained at historically low levels, although the Bank of England and US Federal Reserve began raising interest rates.
- Traded VaR increased on an average basis compared to 2016, but remained within risk appetite. This was partly because the level of risk was reduced in H1 2016 as a result of concerns over the stability of the financial sector, leading to a lower average risk profile for that year. The risk profile subsequently returned to a more normalised level. Refinements to the VaR methodology used for certain credit products also contributed to the increase.

Sources of risk (unaudited)

The primary objective of RBS's trading activities is to provide a range of financing, risk management and investment services to its customers including major corporations and financial institutions around the world. From a market risk perspective, the trading activities are focused on the following markets: rates; currencies; securitised products; and traded credit.

RBS undertakes transactions in financial instruments including debt securities, loans, deposits and equities, as well as securities financing and derivatives.

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Following the reintegration of legacy portfolios, traded market risk now almost entirely resides in the NatWest Markets franchise. The key categories of traded market risk are:

- Interest rate risk which is the risk that a position's fair value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship.
- Credit spread risk which is the risk that the value of a position will change due to changes in the real or market-perceived ability of a borrower to pay related cash flows or obligations.
- Foreign currency price risk which is the risk that the fair value of a position will change due to the change in foreign currency rates, including gold.
- Equity price risk which is the risk that the fair value of a position will change due to the change in equity prices.
- Commodity price risk which is the risk that the fair value of a position will change due to the change in commodity prices.

Trading activities may also give rise to counterparty credit risk. For information on the management of this risk, refer to the Credit risk section on page 181.

Risk governance (unaudited)

Responsibility for identifying, measuring, monitoring and controlling the market risk arising from trading activities lies with the relevant trading business, with second-line-of-defence oversight provided by the Traded Market Risk function.

Traded market risk positions are reported monthly to the Executive Risk Forum (ERF) and quarterly to the Board Risk Committee.

Market risk policy statements set out the governance and risk management framework through effective identification, measurement, reporting, mitigation, monitoring and control.

Risk appetite (unaudited)

RBS's qualitative appetite for traded market risk is set out in the traded market risk appetite statement.

Its quantitative appetite is expressed in terms of exposure limits in the form of Board risk measures (approved by the RBS Board on the recommendation of the Board Risk Committee) and key risk measures (approved by the Technical Executive Risk Forum).

These limits are cascaded further down the organisation as required, as approved by the Technical Executive Risk Forum.

The limit framework at RBS level comprises value-at-risk (VaR) and stressed value-at-risk (SVaR). More details on these are provided on the following pages.

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The limit framework at trading unit level also comprises additional metrics that are specific to the market risk exposures within its scope. These additional metrics aim to control various risk dimensions such as product type, exposure size, aged inventory, currency and tenor.

For each trading business, a document known as a dealing authority compiles details of all applicable limits and trading restrictions.

The limits are reviewed to reflect changes in risk appetite, business plans, portfolio composition and the market and economic environments.

To ensure approved limits are not breached and that RBS remains within its risk appetite, triggers at RBS and lower levels have been set such that if exposures exceed a specified level, action plans are developed by the front office and Traded Market Risk.

For further information on risk appetite, refer to page 156.

Business review **Capital and risk management**

Traded market risk continued

Risk controls and assurance (unaudited)

For information on risk controls and assurance, refer to page 158.

Risk identification and assessment (unaudited)

Identification and assessment of traded market risk is achieved through gathering, analysing, monitoring and reporting market risk information at desk, business, franchise and RBS-wide levels. Industry expertise, continued system developments and techniques such as stress testing are also used to enhance the effectiveness of the identification and assessment of all material market risks.

This is complemented by the New Product Approval process, in which the market risk team participates to assess and quantify the market risk associated with all proposed new products.

Risk monitoring (unaudited)

Traded market risk exposures are monitored against limits and analysed daily by market risk reporting and control functions. A daily report that summarises market risk exposures against the limits at RBS, franchise, business and desk levels is sent to senior management and market risk managers across the function.

The Market Risk function also prepares daily risk reports that detail exposures against a more granular set of limits and triggers.

Limit reporting is supplemented with regulatory capital and stress testing information as well as ad hoc reporting.

A risk review of trading businesses is undertaken weekly with senior risk and front office staff. This includes a review of profit and loss drivers, notable position concentrations and other positions of concern.

Businesses' profit and loss performance is monitored automatically through loss triggers which, if breached, require a remedial action plan to be agreed between the Market Risk function and the front office. The loss triggers are set using both a fall-from-peak approach and an absolute loss level.

In addition, as noted under Risk governance above, regular updates on traded market risk positions are provided to the ERF and Board Risk Committee.

Risk measurement

RBS uses a comprehensive set of methodologies and techniques to measure traded market risk, namely VaR, SVaR and the incremental risk charge. Risks that are not adequately captured by VaR or SVaR are captured by the Risks not in VaR (RNIV) framework to ensure that RBS is adequately capitalised for market risk. In addition, stress testing is used to identify any vulnerabilities and potential losses in excess of VaR and SVaR.

The key inputs into these measurement methods are market data and risk factor sensitivities. Sensitivities refer to the changes in trade or portfolio value that result from small changes in market parameters that are subject to the market risk limit framework. Revaluation ladders are used in place of sensitivities to capture the impact of large moves in risk factors or the joint impact of two risk factors.

These methods have been designed to capture correlation effects and allow RBS to form an aggregated view of its traded market risk across risk types, markets and business lines while also taking into account the characteristics of each risk type.

Value-at-risk (unaudited)

For internal risk management purposes, VaR assumes a time horizon of one trading day and a confidence level of 99%.

The internal VaR model which captures all trading book positions including those products approved by the regulator is based on a historical simulation, utilising market data from the previous 500 days on an equally weighted basis.

The model also captures the potential impact of the following key risk factors: interest rate risk; credit spread risk; foreign currency price risk; equity price risk; and commodity price risk. These are defined under Sources of risk.

When simulating potential movements in risk factors, a combination of absolute, relative and rescaled returns is used, depending on the risk factor.

The performance and adequacy of the VaR model are tested on a regular basis through the following processes:

- **Back-testing** Internal and regulatory back-testing is conducted on a daily basis. (For information on internal back-testing, refer to page 219.)
- **Ongoing model validation** VaR model performance is assessed both regularly and on an ad-hoc basis if market conditions or book constitution change significantly.
- **Model Risk Management review** As part of the model lifecycle, all risk models (including the VaR model) are independently reviewed to ensure that the model is still fit for purpose given current market conditions and book constitution (refer to page 158).

Business review **Capital and risk management**

Traded market risk *continued*

1-Day 99% traded internal VaR (unaudited)

Traded VaR (1-day99%)

The table below analyses 1-day 99% internal VaR for RBS's trading portfolios, segregated by type of market risk exposure.

	2017				2016			
	Average	Maximum	Minimum	Period end	Average	Maximum	Minimum	Period end
	£m	£m	£m	£m	£m	£m	£m	£m
Interest rate	14.1	24.5	8.8	15.3	12.5	22.3	7.8	16.9
Credit spread	12.1	19.4	8.8	16.7	9.5	13.7	5.8	9.7
Currency	4.9	10.0	2.3	3.5	4.6	14.3	1.0	5.4

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Equity	1.2	2.1	0.4	0.4	0.5	2.1	0.2	1.9
Commodity	0.4	1.3		0.2	0.7	2.4	0.2	0.3
Diversification (1)	(12.8)			(15.3)	(10.8)			(10.4)
Total	19.9	29.5	13.2	20.8	17.0	29.3	9.9	23.8

Note:

(1) RBS benefits from diversification as it reduces risk by allocating positions across various financial instrument types, currencies and markets. The extent of the diversification benefit depends on the correlation between the assets and risk factors in the portfolio at a particular time. The diversification factor is the sum of the VaR on individual risk types less the total portfolio VaR.

Key points

- Traded VaR fluctuated throughout 2017, reflecting political developments, market events, customer flows and other macroeconomic factors.
- On an average basis, total traded VaR increased in 2017 compared to 2016, but remained within risk appetite. This was partly because the level of risk was reduced in H1 2016 as a result of concerns over the stability of the financial sector, leading to a lower average risk profile for that year. The risk profile subsequently returned to a more normalised level. Refinements applied to the VaR methodology used for certain credit products during 2017 also contributed to the increase.
- On a period-end basis, total traded VaR was in the middle of the range for the year.

Business review **Capital and risk management**

Traded market risk *continued*

VaR back-testing (unaudited)

The main approach employed to assess the ongoing performance of the VaR model is back-testing, which counts the number of days when a loss exceeds the corresponding daily VaR estimate, measured at a 99% confidence level.

Two types of profit and loss (P&L) are used in back-testing comparisons: Actual P&L and Hypothetical (Hypo) P&L.

The Actual P&L for a particular business day is the firm's actual P&L for that day in respect of the trading activities, including any intraday activities, adjusted by stripping out fees and commissions, brokerage, and additions to and releases from reserves that are not directly related to market risk.

The Hypo P&L reflects the firm's Actual P&L excluding any intra-day activities.

A portfolio is said to produce a back-testing exception when the Actual or Hypo P&L exceeds the VaR level on a given day. Such an event may be caused by a large market movement or may highlight issues such as missing risk factors or inappropriate time series. Any such issues identified are analysed and addressed through taking appropriate remediation or development action. Both Actual and Hypo back-testing exceptions are monitored.

The table below shows internal back-testing exceptions for a period of 250 days for 1-day 99% traded internal VaR vs. Actual and Hypo P&L for major NatWest Markets businesses.

Description	Back-testing exceptions (from 16 January 2017)	
	Actual	Hypo
Rates		
Credit	2	2
Currencies		1
Securitised products	1	1

Key points (unaudited)

- Statistically RBS would expect to see back-testing exceptions 1% of the time over the 250-day period.

- The number of exceptions observed in 2017 for major businesses in NatWest Markets was broadly in line with this expectation.

Business review **Capital and risk management**

Traded market risk *continued*

Stressed VaR (SVaR) (unaudited)

As with VaR, the SVaR methodology produces estimates of the potential change in the market value of a portfolio, over a specified time horizon, at a given confidence level. SVaR is a VaR-based measure using historical data from a one-year period of stressed market conditions.

The risk system simulates 99% VaR on the current portfolio for each 250-day period from 2005 to the current VaR date, moving forward one day at a time. The SVaR is the worst VaR outcome of the simulated results.

This is in contrast with VaR, which is based on a rolling 500-day historical data set. A time horizon of ten trading days is assumed with a confidence level of 99%.

The internal traded SVaR model captures all trading book positions.

10-day 99% trading internal SVaR (unaudited)

	Period- end 2017 £m	Period- end 2016 £m
RBS	172	161

Key point (unaudited)

- Traded SVaR fluctuated throughout 2017, reflecting political developments, market events, customer flows and other macroeconomic factors. On a period-end basis, traded SVaR in 2017 remained at a similar level to 2016.

Risks not in VaR (RNIVs) (unaudited)

The RNIV framework is used to identify and quantify market risks that are inadequately captured by the internal VaR and SVaR models.

RNIV calculations form an integral part of ongoing model and data improvement efforts to capture all market risks in scope for model approval in VaR and SVaR.

Stress testing (unaudited)

For information on stress testing, refer to page 161.

Incremental risk charge (IRC) (unaudited)

The IRC model quantifies the impact of rating migration and default events on the market value of instruments with embedded credit risk (in particular, bonds and credit default swaps) that are held in the trading book. It further captures basis risk between different instruments, maturities and reference entities.

Model validation (unaudited)

RBS uses a variety of models to manage and measure market risk. These include pricing models (used for valuation of positions) and risk models (for risk measurement and capital calculation purposes). They are developed and signed off in NatWest Markets, with material models subject to independent review by Model Risk Management.

For general information on the independent model validation carried out by Model Risk Management, which applies also to market risk models (including VaR models), refer to page 158. Additional details relating to pricing and market risk models are presented below.

Pricing models

Pricing models are developed by a dedicated front office quantitative team, in conjunction with the trading desk. They are used for the valuation of positions for which prices are not directly observable and for the risk management of the portfolio.

Any pricing models that are used as the basis for valuing books and records are subject to approval and oversight by asset-level modelled product review committees.

These committees comprise representatives of the major stakeholders in the valuation process - trading, finance, market risk, model development and model review functions. Model approval by such a committee requires review and approval by these stakeholders, including independent model review by Model Risk Management.

The review process includes the following steps:

- The committees prioritise models for review by Model Risk Management, considering the materiality of the risk booked against the model and an assessment of the degree of model risk, that is the valuation uncertainty arising from the choice of modelling assumptions.

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- Model Risk Management quantifies the model risk, which may include comparing front office model outputs with those of alternative models independently developed by Model Risk Management.
- The sensitivities derived from the pricing models are validated.
- The conclusions of the review are used to inform risk limits and by Finance to inform model reserves.

Risk models

All model changes are approved through model governance committees at franchise level. Changes to existing models are subject to Model Risk Management review and RBS follows regulatory guidance for assessing the materiality of extensions and changes to the internal model approach for market risk.

Model Risk Management's independent oversight provides additional assurance that RBS holds appropriate capital for the market risk to which it is exposed.

In addition to Model Risk Management's independent oversight, the model testing team monitors the model performance for market risk through back-testing, which is discussed in more detail on page 219, and other processes.

Business review Capital and risk management

Traded market risk [continued](#)

Linkage to balance sheet (unaudited)

The table below analyses RBS's balance sheet by non-trading and trading business.

	2017			2016			Primary risk factor
	Total	Non-trading business (1)	Trading business (2)	Total	Non-trading business (1)	Trading business (2)	
	£bn	£bn	£bn	£bn	£bn	£bn	
Assets							
Cash and balances at central banks	98.3	98.3		74.3	74.2	0.1	Interest rate
Net loans and advances to banks	16.3	9.3	7.0	17.3	10.4	6.9	Interest rate
Net loans and advances to customers	323.2	307.9	15.3	323.0	304.9	18.1	Interest rate
Reverse repos	40.7	4.5	36.2	41.8	4.1	37.7	Interest rate
Debt securities	78.9	51.4	27.5	72.5	48.0	24.5	Interest rate, credit spreads
Equity shares	0.5	0.4	0.1	0.7	0.5	0.2	Equities
Derivatives	160.8	1.6	159.2	247.2	3.0	244.2	Interest rate, credit spreads
Settlement balances	2.5		2.5	5.5	0.1	5.4	Settlement risk
Other assets	16.9	16.9		16.4	16.4		
Total assets	738.1	490.3	247.8	798.7	461.6	337.1	
Liabilities							
Deposits by banks	39.5	27.0	12.5	33.3	12.6	20.7	Interest rate
Customer deposits	367.0	355.2	11.8	353.9	340.7	13.2	Interest rate
Repos	38.4	10.1	28.3	32.3	5.0	27.3	Interest rate
Debt securities in issue	30.6	28.0	2.6	27.3	22.9	4.4	Interest rate
Settlement balances	2.8		2.8	3.6	0.1	3.5	Settlement risk
Short positions	28.5		28.5	22.1		22.1	Interest rate, credit spreads
Derivatives	154.5	1.5	153.0	236.5	1.9	234.6	Interest rate, credit spreads
Subordinated liabilities	12.7	12.7		19.4	19.4		Interest rate
Other liabilities	15.0	15.0		20.9	20.9		
Total liabilities	689.0	449.5	239.5	749.3	423.5	325.8	

Notes:

(1) Non-trading businesses are entities that primarily have exposures that are not classified as trading book. For these exposures, with the exception of pension-related activities, the main measurement methods are sensitivity analysis of net interest income, internal non-traded VaR and fair value calculations. For more information refer to pages 208 to 215.

(2) Trading businesses are entities that primarily have exposures that are classified as trading book under regulatory rules. For these exposures, the main methods used by RBS to measure market risk are detailed under traded market risk measurement on pages 216 to 221.

(3) Foreign exchange risk affects all non-sterling denominated exposures on the balance sheet across trading and non-trading businesses, and therefore has not been listed in the above tables.

Business review **Capital and risk management**

Pension risk (unaudited)

Definition

Pension obligation risk is the risk to RBS caused by its contractual or other liabilities to, or with respect to, a pension scheme (whether established for its employees or those of a related company or otherwise). It is also the risk that RBS will make payments or other contributions to, or with respect to, a pension scheme because of a moral obligation or because RBS considers that it needs to do so for some other reason.

Sources of pension risk

RBS has exposure to pension risk through its defined benefit schemes worldwide. The five largest schemes, which represent around 98% of RBS's pension liabilities are: the Main Section of The Royal Bank of Scotland Group Pension Fund (the Main scheme), the AA Section of The Royal Bank of Scotland Group Pension Fund, the Ulster Bank Pension Scheme, the Ulster Bank Pension Scheme (Republic of Ireland), and the Royal Bank of Scotland International Pension Trust. The Main scheme is the principal source of pension risk. Further detail on RBS's pension obligations can be found in Note 4 on the consolidated accounts.

Pension scheme liabilities vary with changes in long-term interest rates and inflation as well as with pensionable salaries, the longevity of scheme members and legislation. Pension scheme assets vary with changes in interest rates, inflation expectations, credit spreads, exchange rates, and equity and property prices. RBS is exposed to the risk that the schemes' assets, together with future returns and additional future contributions, are insufficient to meet liabilities as they fall due. In such circumstances, RBS could be obliged (or might choose) to make additional contributions to the schemes, or be required to hold additional capital to mitigate this risk.

Prior to 6 April 1997, individuals who contracted out of the UK State Second Pension were entitled to a Guaranteed Minimum Pension (GMP). Men accrued GMP at different rates to women. The Government intends that GMP should be equalised but until the mechanism is defined, pension funds are uncertain of their obligations. In the meantime, no allowance is made for GMP equalisation in the IAS 19 defined benefit obligations and risk disclosures.

Key developments in 2017

A memorandum of understanding between Ulster Bank Ireland DAC and Ulster Bank Pension Trustees Limited was agreed. A contribution of 200 million was paid to the pension scheme and the investment strategy amended to include more hedging assets.

Throughout 2017, various pension risk stress-testing initiatives were undertaken, focused both on internally-defined scenarios and on scenarios to meet integrated Bank of England stress-testing requirements. For more information on stress testing, refer to the following page.

Pension risk management function

Risk governance

The Main scheme operates under a trust deed. The corporate trustee, RBS Pension Trustee Limited, is a wholly owned subsidiary of National Westminster Bank Plc. The trustee board comprises six directors selected by RBS and four directors representing members. The trustee is supported by RBS Investment Executive Ltd (RIEL), which specialises in pension investment strategy.

The Pension Committee, which is chaired by the RBS Chief Financial Officer, acts as a sub-committee of the Executive Committee and formulates RBS's view of pension risk. The Pension Committee considers mechanisms that could potentially be used for managing risk within the funds as well as financial strategy. The Pension Committee is a key component of RBS's approach to managing pension risk and it reviews and monitors risk management, asset strategy and financing issues on behalf of RBS. The Pension Committee also serves as a formal link between RBS, RIEL and the trustee.

For further information on Risk governance, refer to page 154.

Risk appetite

Investment policy for the schemes is defined by the trustee with input from RIEL where appropriate and other specialist advisers employed by the trustee. While the trustee is responsible for the management of the scheme assets, it consults with RBS on material changes to the Main scheme's risk appetite and investment policy.

RBS maintains an independent view of the risk inherent in pension funds, with an associated risk appetite, and has defined metrics against which risk is measured. In addition to the scrutiny provided by the Pension Committee, RBS undertakes regular pension risk monitoring and reporting to the Board and the Board Risk Committee on the material pension schemes that RBS has an obligation to support.

Risk controls

A pension risk management framework is in place to provide formal controls for pension risk reporting, modelling, governance and stress testing. A pension risk policy which sits within the RBS policy framework is also in place and is subject to associated framework controls.

Risk identification and measurement

Pension risk reports are submitted to the Executive Risk Forum and the Board Risk Committee four times a year in the Risk & Conduct Management Quarterly Report. This includes an assessment of the overall deficit or surplus position, estimated capital requirements, and an assessment of the associated assets and liabilities.

Business review Capital and risk management

Pension risk (unaudited) continued

RBS also undertakes stress tests and scenario analyses on its material defined benefit pension schemes each year as part of its risk measurement framework. These stress tests are also used to satisfy the requests of regulatory bodies such as the Bank of England. The stress testing framework includes pension risk capital calculations for the purposes of the Internal Capital Adequacy Assessment Process as well as additional stress tests for a number of internal management purposes.

Pension stress tests take the form of both stochastic and deterministic stresses over time horizons ranging from instantaneous to seven years in duration. They are designed to examine the behaviour of the pension schemes' assets and liabilities under a range of financial and demographic shocks. The results of the stress tests and their consequential impact on RBS's balance sheet, income statement and capital position are incorporated into the overall RBS-wide stress test results.

RBS Group plc is the parent of several entities that participate in the Main scheme, and which could be required to fund any deficit that arises. The table below shows the sensitivity of the Main scheme's assets and liabilities (measured according to IAS 19 Employee Benefits). It includes changes in interest rates and equity values at the year-end, taking account of the current asset allocation and hedging arrangements.

	Increase in value of assets £m	Increase in value of liabilities (obligations) £m	Increase in net pension assets/ (obligations) £m
2017			
Fall in nominal swap yields of 0.25% at all durations with no change in credit spreads or real swap yields	1,199	750	449
Fall in real swap yields of 0.25% at all durations with no change in credit spreads or nominal swap yields	1,289	1,329	(40)
Fall in AA credit spreads of 0.25% at all durations with no change in nominal or real swap yields or other credit spreads	7	2,055	(2,048)
Fall in equity values of 10% (1)	(909)		(909)
2016			
Fall in nominal swap yields of 0.25% at all durations with no change in credit spreads or real swap yields	1,048	502	546
Fall in real swap yields of 0.25% at all durations with no change in credit spreads or nominal swap yields	1,485	1,552	(67)
Fall in AA credit spreads of 0.25% at all durations with no change in nominal or real swap yields or other credit spreads	9	2,074	(2,065)
Fall in equity values of 10% (1)	(905)		(905)

Note:

(1) Includes both quoted and private equity.

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The chart below shows the pension liability cash flow profile, allowing for expected indexation of future payments. The majority of expected cash flows (84%) are anticipated within the next 40 years. The profile will vary depending on the assumptions made regarding inflation expectations and mortality.

Business review **Capital and risk management**

Pension risk (unaudited) *continued*

Risk mitigation

The trustee has taken measures to mitigate inflation and interest rate risks, both by investing in suitable financial assets and by entering into inflation and interest rate swaps. The Main scheme also uses derivatives to manage the allocation of the portfolio to different asset classes and to manage risk within asset classes.

The assets of the Main scheme, which represented around 90% of RBS's pension plan assets at 31 December 2017, are invested in a diversified portfolio. This includes quoted and private equity, government and corporate fixed interest and index-linked bonds, property and other alternative assets.

Future developments

The UK ring-fencing regime will require significant changes to the structure of RBS's existing defined benefit pension schemes. From 2026 it will not be possible for any of the entities inside the ring-fence (or their wholly-owned subsidiaries) to participate in the same defined benefit pension scheme as entities outside the ring-fence.

RBS is developing a strategy to meet these requirements. This will require the agreement of the pension scheme trustee. RBS's intention is for the Main scheme to be supported by entities within the ring-fence. This could result in the pension scheme trustee concluding that the employer covenant (the ability of participating employers to support the scheme) has been weakened as a result of the entities outside the ring-fence no longer participating in the pension scheme, and as a result requesting additional contributions. Discussions with respect to the above issues are ongoing with the trustee.

The last triennial valuation of the Main scheme had an effective date of 31 December 2015. This valuation was concluded with the acceleration of the nominal value of all committed contributions in respect of past service (£4.2 billion), which was paid in the first quarter of 2016.

The next triennial valuation will have an effective date of 31 December 2018. The expectation is that this will result in additional contributions being agreed with the trustee. Under current legislation, such agreement would need to be reached no later than 31 March 2020.

The aggregate contributions RBS commits to will therefore depend not only on the size of any deficit arising from the triennial valuation (on assumptions that must be agreed with the trustee), but also on the extent to which RBS needs to provide additional mitigation for any perceived weakening in the covenant as a result of ring-fence restructuring. The assumptions to be agreed with the trustee will include the discount rate (the rate at which future cash flows are discounted to arrive at a present value of the total pension scheme liabilities) as well as a range of other assumptions such as recent changes to life expectancy projections.

The trustee estimates that, as at 30 June 2017, the Main scheme had a surplus of £1.7 billion on the technical provisions assumptions agreed for the 31 December 2015 triennial valuation (the methodology for deriving these assumptions is shown in Note 4 on the consolidated accounts). A 25 basis point (0.25%) reduction in the technical provisions discount rate reduces the surplus position by around £2.4 billion.

This sensitivity to the discount rate assumption is greater than the sensitivity of the IAS 19 obligation of £2.0 billion to a 25 basis point change in the discount rate, shown in Note 4 on the consolidated accounts, as a result of two factors:

- The technical provisions liability is greater than the IAS 19 obligation, meaning a proportionate change would have a larger absolute impact.
- Different assumptions are used for technical provisions (for example longevity).

Business review **Capital and risk management**

Conduct risk (unaudited)

Definition

Conduct risk is the risk that the behaviour of RBS and its staff towards customers, or in the markets in which it operates, leads to unfair or inappropriate customer outcomes resulting in reputational damage, financial loss or both. The damage or loss may be the result of a failure to comply with (or adequately plan for changes to) relevant official sector policy, laws, regulations, or major industry standards, or of failing to meet the expectations of customers or regulators.

Sources of conduct risk

Conduct risk exists across all stages of RBS's relationships with its customers – from the development of its business strategies, to post-sales processes – and arises from a variety of activities. These include product design, marketing and sales, complaint handling, staff training, and handling of confidential insider information. Conduct risk also arises if RBS does not take effective action to prevent fraud, bribery and money laundering. As set out in Note 31 on the consolidated accounts, RBS and certain members of staff are party to legal proceedings and are subject to investigation and other regulatory action in the UK, the US and other jurisdictions.

Key developments in 2017

Parts of the Conduct & Regulatory Affairs function were merged with the Risk function with effect from 1 January 2017. Regulatory Affairs moved to Corporate Governance & Secretariat while Remediation and Complaints moved to Services – Chief Operating Office. The change was designed to take advantage of synergies across the risk, conduct and regulatory agendas.

RBS continued to remediate historical conduct issues, while also focusing its customer-facing businesses and support functions around the needs of its customers including the delivery of a number of regulatory change programmes. Conduct and litigation costs were £1.1 billion in 2017 compared with £5.9 billion in 2016.

- The remediation of PPI continued, with the FCA confirming August 2019 as the deadline for PPI mis-selling claims.
- The FCA is reviewing the business models of UK retail banks, building societies and credit unions, to understand how recent changes are affecting competition and conduct in the sector.
- Following an enforcement notice from the Central Bank of Ireland in respect of tracker mortgages, a significant remediation programme was established.
- Work progressed to meet the requirements of the revised Markets in Financial Instruments Directive and Regulation (MiFID II/MiFIR) in advance of their introduction in early 2018.
- Work also progressed on the conduct-related aspects of the UK's ring-fencing requirements.

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- Changes were implemented to support compliance with the second Payment Services Directive in advance of its introduction in early 2018.
- RBS updated its policies to reflect changes required in relation to the 4th Money Laundering directive, which came into force in H1 2017 to combat terrorist and criminal financing.
- The Criminal Finances Act 2017 came into force in H2 2017, introducing a new corporate offence of failure to prevent the facilitation of tax evasion. Policies and procedures in place to prevent such activity were reviewed and enhanced.

Conduct risk management function

The management of conduct risk is based on seven key elements, ensuring that conduct risk exposures are understood and managed in accordance with agreed risk appetite.

Risk governance

RBS defines appropriate standards of conduct and drives adherence to those standards through its framework for managing conduct risk. The Board and its senior committees receive updates on conduct risk exposures and action plans through regular reporting.

Key elements of the governance structure are set out below:

- The Risk, Conduct & Restructuring Executive Committee considers emerging material risks and issues, and implements Board and Executive Committee risk management policy decisions.
- The Financial Crime Risk Executive Committee (accountable to the Executive Risk Forum) ensures that the customer-facing businesses and the Services function fulfil strategic objectives by identifying and managing their financial crime risks effectively.

Controls

Under the policy framework, there are 18 conduct policies. These are designed to provide both high-level direction and stipulate RBS-wide requirements. The policies provide the necessary clarity to staff on their conduct obligations and ensure RBS meets its regulatory obligations.

Business review **Capital and risk management**

Conduct risk (unaudited) *continued*

Risk assessments are used to identify material conduct risks and inform key controls across all business areas. The risk assessment process is designed to confirm risks are effectively managed and prioritised. The process also ensures controls are tested.

Scenario analysis is used to assess the impact of extreme but plausible conduct risks including financial crime. The scenarios assess the exposures that could significantly affect RBS's financial performance or reputation and are an important component in the operational risk framework and capital model.

Risk appetite

The conduct risk appetite framework was established in 2015 and has been embedded across RBS.

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The conduct risk appetite framework and the Conduct Performance Assessment, which forms part of it, facilitate a consistent approach across RBS for assessing conduct risk.

The conduct risk appetite statements, in line with RBS-wide risk appetite, articulate the levels of risk which franchises and functions must not exceed. Where businesses are operating outside conduct appetite, the problems are addressed through agreed risk mitigation plans.

The Conduct Performance Assessment was run in Q1 and Q3 2017, reporting on risk exposures and the operating effectiveness of controls across the businesses. During Q4 2017, the Conduct Performance Assessment was discontinued, in advance of the roll-out of a new approach in early 2018, providing a real-time quantitative view, supported by qualitative assessment.

Risk monitoring and measurement

The Board and senior RBS committees receive updates on conduct risk exposures and action plans through regular reporting. The reporting is intended to be focused, forward-looking and action-oriented.

The most material conduct matters are reported to the appropriate committees, including the Board, the Group Audit Committee and Board Risk Committee.

An annual Money Laundering Reporting Officer's Report is submitted to the Board and shared with the FCA. This covers RBS's Anti-Money Laundering (AML) framework and the operation and effectiveness of the systems and controls in place to comply with AML laws and regulations. In addition, it covers the systems and controls in place to prevent the financing of terrorism and to ensure compliance with sanctions.

The Group Audit Committee is provided with a whistleblowing report twice a year. The report comments on the operational effectiveness of our whistleblowing framework, internally branded as 'Speak Up', and any trends emerging from completed investigations. It details cases by internal reporting categories based on the RBS definition of whistleblowing included in the Speak Up policy.

The Speak Up policy encompasses both the legislative definition contained within the Public Interest Disclosure Act 1998 and the regulatory definition within FCA and PRA regulations and guidance. It extends these to include conduct or behaviour which does not meet the expected standards documented in Our Code.

Each business in RBS has enhanced its use of management information by linking it to the relevant Conduct risk appetite statements. This is required to help ensure appropriate customer outcomes are delivered and that the management information is compliant with the Basel Committee on Banking Supervision's principles for effective risk data aggregation and risk reporting.

Risk mitigation

Information is communicated to each customer-facing business and function about regulatory developments and discussions with regulators. This helps identify and execute any required changes to strategy or to business models.

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Early identification and effective management of changes in legislation and regulation are critical to the successful mitigation of conduct risk. The effects of all changes are managed to ensure timely compliance readiness. Changes assessed as having a high or medium-high impact are managed closely.

Mandatory learning, across RBS, helps to ensure colleagues have the information necessary to carry out their duties in a way that complies with expected standards.

Business review **Capital and risk management**

Operational risk (unaudited)

Definition

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or external events. It arises from day-to-day operations and is relevant to every aspect of the business.

Operational risk may directly affect customers, lead to financial loss or damage RBS's reputation (for example, cyber attacks, a major IT systems failure or fraudulent activity). There can also be a link between operational risk failures and conduct risk issues.

Sources of operational risk

Operational risk may arise from a failure to manage operations, systems, transactions and assets appropriately. This can take the form of human error, an inability to deliver change adequately or on time, the non-availability of technology services, or the loss of customer data. Fraud and theft are sources of operational risk, as is the impact of natural and man-made disasters. It can also arise from a failure to account for changes in law or regulations or to take appropriate measures to protect assets.

Key developments in 2017

RBS continued to work to embed its enhanced operational risk framework, improving links between risk appetite and risk exposure and building a more robust control environment.

The year also saw a continued focus on the risks arising from the execution of major projects, including: the Transformation portfolio; the restructuring of NatWest Markets; preparations for the implementation of the corporate structural reform agenda – for example the Independent Commission on Banking's ring-fencing proposals, recovery and resolution planning, as well as Brexit; the planned activities to meet the European Commission state aid obligations; and, the effect on RBS's control environment due to cost reduction measures. These projects are essential in order for RBS to achieve its strategic objectives. Risk, Conduct & Restructuring ensured the associated risks to these projects were assessed and understood with mitigating activity in place wherever possible.

There was also a strong focus on RBS's risk and control assessment methodology. Following on from work carried out in 2016, the aim of this consistent, bank-wide methodology was to enhance understanding of the risk profile for the most critical products and services. In 2017, coverage was significantly extended across RBS, with outputs used to inform Group-wide reporting.

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The external fraud threat remained high with data used by organised crime gangs to deceive customers through social engineering, and the continued evolution of financial malware. In 2017, there was an increase in fraud perpetrated by scams. RBS has a bank-wide response plan to address the increased threat, which focuses on profiling capabilities and educating customers about fraud protection as well as continued work to drive and support industry best practice. This aligned with fraud prevention programmes across RBS, with the objective of mitigating the effects of external fraud on customers and RBS itself. The plan was successfully implemented and key strategic initiatives enhanced RBS's fraud prevention and detection capabilities, enabling it to limit the effects of fraudulent activity on its customers. As a result, RBS recorded a year-on-year decrease in the number of its customers falling victim to fraud in 2017.

RBS continued to support an industry-led education initiative 'Take Five to Stop Fraud' which offers advice to help the public protect themselves from preventable financial fraud. The initiative is led by Financial Fraud Action UK Ltd and is being delivered in conjunction with the Home Office, law enforcement and other banks.

The information and cyber security risk facing RBS continued to change in line with the constantly evolving threats. Internal security improvement programmes progressed across RBS, developing new and strengthening existing controls in order to protect the Group and its customers. RBS continuously developed and used proactive threat management and intelligence processes to understand, manage and mitigate credible threats.

RBS decommissioned a number of internet-facing websites to reduce the attack surface visible to hackers and fraudsters. Improvements were also made to prevent data leakage, secure externally bound email, as well as enhance malware defences and management of user access to key systems. Internal training programmes continued to ensure all employees are fully aware of the threats facing RBS and remain vigilant to unauthorised attempts by internal or external parties to access systems and data.

Operational risk management function

Risk governance

A strong operational risk management function is vital to support RBS's ambitions to serve its customers better. Improved management of operational risk against a defined appetite directly supports the strategic risk objective of improving stakeholder confidence and is vital for stability and reputational integrity.

The operational risk function, which is the second line of defence, is tasked with delivering a robust operational risk management framework and culture across RBS. The Director of Operational Risk reports to the Chief Risk Officer.

Business review **Capital and risk management**

Operational risk (unaudited) *continued*

Operational risk is responsible for the design, development, delivery and continuous improvement of the operational risk management framework. The Operational Risk Policy is incorporated into the RBS Policy Framework and provides direction for the consistent identification, assessment, management, monitoring and reporting of operational risk. Through a network of oversight teams, the function seeks to ensure the integrity of the framework, and manages overall operational risk profile against risk appetite.

The Operational Risk Executive Committee (OREC), which is a sub-committee of the Executive Risk Forum (ERF), acts on all operational risk matters. OREC's duties include reviewing operational risk exposure against risk appetite; identifying and assessing both current and emerging material operational risks; reviewing and monitoring the operational risk profile; and reviewing and approving material operational risk policy management framework changes.

Risk appetite

The operational risk appetite framework supports effective management of key operational risks. It expresses the level and types of operational risk RBS is willing to accept in order to achieve its strategic objectives and business plans.

RBS's operational risk appetite is expressed through a set of qualitative risk appetite statements and quantitative measures which are defined at an aggregate, RBS-wide and individual business level. Appetite covers RBS's most material operational risks, defined by a materiality assessment, which in turn considers past, current and future risk exposures. Appetite exposures for all material risks are regularly reported to business risk committees, the OREC, ERF and Board Risk Committee.

The aggregation of operational risk appetite allows RBS to monitor and report on its material risk exposures against predetermined limits. This drives management intervention and action at defined points, such as the breach of an early warning trigger.

Above these sit an RBS-level operational risk appetite statement which encompasses the full range of operational risks. This drives the strategic risk measurement of stakeholder confidence and is reviewed annually by the ERF. The statement is supported by three simple measures: (i) the relationship between operational risk losses and RBS's gross income; (ii) metrics covering control environment performance; and (iii) the requirement for the material RBS-wide operational risks to be managed within risk appetite.

Risk controls

The Control Environment Certification (CEC) process is a half yearly self-assessment by the CEOs of RBS's customer-facing franchises and business units, as well as the heads of the Group's support and control functions. It gives an assessment on the adequacy and effectiveness of the

internal control environment in a consistent and comparable manner, highlighting areas where targeted effort is needed to meet the standards required in order to create a safer and more secure bank for customers. It covers material risks and the key controls that underpin them, including financial, operational and compliance controls, as well as supporting risk management frameworks.

The CEC outcomes, including forward-looking assessments for the next two half-yearly cycles and the progress made to improve the control environment, are reported to the Board, the Group Audit Committee and the Board Risk Committee. They are also shared with external auditors.

The CEC process helps to ensure compliance with the RBS Policy Framework, Sarbanes-Oxley 404 requirements concerning internal control over financial reporting (as referenced in the Compliance report on page 106), and certain requirements of the UK Corporate Governance Code.

Risk identification and measurement

Across all business areas, risk and control assessments are used to identify and assess material operational and conduct risks and key controls. To support identification of risk concentrations, all risks and controls are mapped to the risk directory. Risk assessments are refreshed at least annually to ensure they remain relevant and capture any emerging risks.

The process is designed to confirm that risks are effectively managed and prioritised in line with the stated risk appetite. Controls are tested at the appropriate frequency to verify that they remain fit-for-purpose and operate effectively.

During 2017, work continued to increase the coverage of the enhanced end-to-end risk and control assessment methodology. This approach, which strengthens understanding of the risk profile of key products and services, is used to identify and quantify the most material operational risks. Subject matter experts and key stakeholders are engaged from across RBS to underpin management action in line with RBS's financial and non-financial appetite statement. The results of the risk and control assessments support RBS's on-going journey to build on, and enhance, its control environment.

Monitoring and reporting are part of RBS's operational risk management processes, which aim to ensure that risks are identified, considered by senior executives, and managed effectively. The most material operational risks and their position relevant to risk appetite are regularly reviewed at the OREC, along with any emerging risks and the actions taken to mitigate them. These are also reported to the Board Risk Committee and the ERF. Exposures specific to each business are communicated through regular risk and control reports discussed at business risk committees.

Business review **Capital and risk management**

Operational risk (unaudited) *continued*

RBS uses the standardised approach to calculate its operational risk capital requirement. This is based on multiplying three years' average historical gross income by coefficients set by the regulator based on type of income.

As part of the wider Internal Capital Adequacy Assessment Process an operational risk economic capital model is used as a key capital benchmark. The model uses loss data and scenario analysis inputs from the operational risk framework, plus external loss data and certain other factors to provide a risk-sensitive view of RBS's operational risk capital requirement.

Scenario analysis is used to assess how extreme but plausible operational risks will affect RBS. It provides a forward-looking basis for evaluating and managing operational risk exposures.

Refer to the Capital, liquidity and funding risk section for operational risk capital requirement figures.

Event and loss data management

The operational risk event and loss data management process ensures RBS captures and records operational risk loss events that meet defined criteria.

Loss data is used for regulatory and industry reporting and is included in capital modelling when calculating economic capital for operational risk.

The most serious events are escalated in a simple, standardised process to all senior management, by way of a Group Notifiable Event Process.

All losses and recoveries associated with an operational risk event are reported against their financial accounting date. A single event can result in multiple losses (or recoveries) that may take time to crystallise. Losses and recoveries with a financial accounting date in 2017 may relate to events that occurred, or were identified in, prior years.

Percentage and value of events

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At 31 December 2017, events aligned to the clients, products and business practices event category accounted for 84% of RBS's operational risk losses (compared to 98% in 2016). The reduction reflects that the level of losses attributable to conduct-related events has significantly reduced compared to prior years. The reduction in conduct-related events also explains the increase in the proportion of events in the execution, delivery and process management category.

	Value of events		Proportion		Volume of events (1)	
	2017	2016	2017	2016	2017	2016
Fraud	49	48	6%	1%	83%	78%
Clients, products and business practices (2)	614	5,411	84%	98%	7%	11%
Execution, delivery and process management	65	40	9%	1%	7%	8%
Employment practices and workplace safety	4	5	1%		3%	3%
Technology and infrastructure failures		1				
	732	5,505	100%	100%	100%	100%

Notes:

(1) The calculation in the above table is based on the volume and value of events where the associated loss is more than or equal to £10,000.

(2) 2016 has been restated from £6,282 million as a loss captured in 2016 has now been determined as a non-qualifying operational risk event.

Risk mitigation

Risks are mitigated through the application of key preventative and detective controls. This is an integral step in the risk assessment methodology, which determines residual risk exposure. Control owners are accountable for the design, execution, performance and maintenance of key controls.

These key controls are regularly assessed for adequacy and tested for effectiveness. The control testing results are monitored and, where a material change in performance is identified, it results in a re-evaluation of the associated risk.

RBS purchases insurance to provide the business with financial protection against specific losses and to comply with statutory or contractual requirements.

Business review **Capital and risk management**

Business risk (unaudited)

Definition

Business risk is the risk that RBS makes inappropriate business or strategic choices or that RBS is not able to execute its chosen strategy in line with its budget.

Sources of risk

Business risk arises as a result of RBS's exposure to the macro-environment, to the competitive environment, and to technological changes. In addition, internal factors such as volatility in sales volumes, and input costs, and other operational risks such as RBS's ability to assess the business operating environment, or to execute its chosen strategy, contribute to business risk.

Key developments in 2017

RBS continued to reduce its business risk profile by implementing its strategic plan to shift the business mix towards the UK and retail and commercial banking segments, with higher risk activities in NatWest Markets curtailed.

RBS also continued with its simplification and cost reduction programmes during 2017.

As negotiations on the prospective withdrawal of the UK from the European Union have progressed, RBS has been closely monitoring and assessing the operating environment and its effect on business risk.

In July 2017, RBS reached a settlement with the Federal Housing Finance Agency, paying US\$5.5 billion to resolve claims in relation to the issuance and underwriting of residential mortgage-backed securities in the US. This was an important step forward in resolving one of the most significant legacy matters facing RBS.

In September 2017, RBS received final approval from the European Commission for its alternative remedies package, designed to promote competition for banking services to the SME marketplace. This approval allows RBS to resolve its final State Aid divestment obligation and brings clarity for customers and staff.

Governance

The Board has ultimate responsibility for business risk and for approving strategic plans, initiatives and changes to strategic direction.

RBS's strategic planning process is managed by Strategy and Corporate Development. The Risk and Finance functions are key contributors to strategic planning.

Responsibility for the day-to-day management of business risk lies primarily with the franchises, with oversight by the Finance function. The franchises are responsible for delivery of their business plans and the management of such factors as pricing, sales volumes, marketing expenditure and other factors that can introduce volatility into earnings.

Risk identification

Business risk is identified and managed at the product and transaction level. Estimated revenue, costs and capital are key considerations in the design of any new product or in any new investment decision.

Business risk is reported, assessed and challenged at every governance level within the organisation. Each franchise monitors its financial performance relative to plans and reports this on a regular basis to the finance directors of each franchise.

Risk mitigation

RBS operates a monthly rolling forecasting process to identify projected changes in, or risks to, key financial metrics, and ensures appropriate actions are taken.

Reputational risk (unaudited)

Definition

Reputational risk is the risk to RBS's public image from a failure to meet stakeholders' expectations in relation to performance, conduct or business profile. Stakeholders include customers, investors, employees, suppliers, government, regulators, special interest and consumer groups, media and the general public.

Sources of risk

Reputational risk can arise from the conduct of employees; activities of customers and the sectors and countries in which they operate; provision of products and transactions; as well as operations and infrastructure.

Governance

Reputational risk has Board-level oversight reinforced by a Reputational Risk Policy. The Board Risk Committee and Sustainable Banking Committee are responsible for overseeing how RBS manages its reputation. The Board's oversight of reputational issues is supported by the senior RBS-wide Reputational Risk Forum (RRF) which opines on cases and issues that represent a material reputational risk to the whole organisation. The RRF, which has delegated authority from the Executive Risk Forum (ERF), also acts as a central forum to review sector or theme-specific reputational risk acceptance positions, including environmental, social and ethical risk positions, for example, in the Defence and

Gambling sectors.

Risk appetite

RBS manages and articulates its appetite for reputational risk through the implementation of a qualitative reputational risk appetite statement and a committee-based governance framework. This has improved the identification, assessment and management of customers, transactions, products and issues that present a material reputational risk, resulting in a greater awareness and focus on the importance of this risk. Moreover, RBS has seen a rise in the number of cases being referred to franchise and group-wide reputational risk fora as a result of increased awareness of the framework as well as training on reputational risk.

Risk mitigation

Reputational risk is mitigated through the policy and governance framework, with ongoing staff training to ensure early identification, assessment and escalation of material issues. Lessons learned from committee meetings have also improved the way cases and issues are debated and decisions made.

The most material threats to RBS's reputation continued to originate from historical and more recent conduct issues. As a result, RBS has been the subject of investigations and reviews by a number of its regulators, some of which have resulted in fines and public censure. Refer to the Litigation, investigations and reviews section of Note 31 on the consolidated accounts on page 304.

Financial statements

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Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of The Royal Bank of Scotland Group plc

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of The Royal Bank of Scotland Group plc (the Group) as at 31 December 2017 and 2016, and the related consolidated statements of income, comprehensive income, changes in equity and cash flows for the two years then ended, the related accounting policies and Notes 1 to 42, and the information identified as audited in the Annual report on remuneration in the Directors Remuneration Report, and in the Capital and risk management section of the Business review (collectively referred to as the financial statements). In our opinion, the financial statements present fairly, in all material respects, the consolidated financial position of the Group at 31 December 2017 and 2016 and the consolidated results of its operations and its cash flows for the two years then ended, in conformity with International Financial Reporting Standards (IFRS) as adopted for use in the European Union and IFRS as issued by the International Accounting Standards Board.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Group's internal control over financial reporting as of 31 December 2017, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework), and our report dated 22 February 2018 expressed an unqualified opinion thereon.

Basis for Opinion

These financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on the Group's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Group in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Ernst & Young LLP

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We have served as the Group's auditors since 2016.

London, United Kingdom

22 February 2018

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of The Royal Bank of Scotland Group plc

Opinion on Internal Control over Financial Reporting

We have audited The Royal Bank of Scotland Group plc's (the Group) internal control over financial reporting as of 31 December 2017, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). In our opinion, the Group maintained, in all material respects, effective internal control over financial reporting as of 31 December 2017, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheet of the Group as of 31 December 2017 and 2016, and the related consolidated statements of income, comprehensive income, changes in equity and cash flows for the two years then ended and our report dated 22 February 2018 expressed an unqualified opinion thereon.

Basis for Opinion

The Group's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Group's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Group in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that

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transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Ernst & Young LLP
London, United Kingdom
22 February 2018

Report of Independent Registered Public Accounting Firm

Report of Independent Registered Public Accounting Firm to the members of The Royal Bank of Scotland Group plc

We have audited the accompanying consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity, and consolidated cash flow statement of The Royal Bank of Scotland Group plc and its subsidiaries (together, the Group) for the year ended 31 December 2015, the accounting policies and notes 1 to 42, and the 2015 information identified as audited in the Capital and risk management section of the Financial review (consolidated financial statements). These consolidated financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such 2015 consolidated financial statements, present fairly, in all material respects, the results of operations and cash flows of The Royal Bank of Scotland Group plc and its subsidiaries for the year ended 31 December 2015, in conformity with International Financial Reporting Standards (IFRS) as adopted for use in the European Union and IFRS as issued by the International Accounting Standards Board.

Note 42 to the consolidated financial statements was added for the inclusion of consolidating financial information in respect of The Royal Bank of Scotland plc in accordance with Regulation S-X Rule 3-10.

As discussed in Note 37 to the consolidated financial statements, the accompanying 2015 consolidated financial statements have been retrospectively adjusted to reflect a change in the reportable segments. Additionally, as discussed in Note 42, retrospective adjustments have been made to reflect changes in presentation in the consolidating financial information footnote resulting from discontinued operations within RBS plc.

/s/ Deloitte LLP

London, United Kingdom

25 February 2016, and 24 March 2016 for the consolidating financial information in Note 42

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(15 December 2017 as to the retrospective adjustments for the change in reportable segments in Note 37 and 9 February 2018 for the retrospective adjustments to reflect changes in presentation in the consolidating financial information in Note 42 resulting from discontinued operations within RBS plc)

Consolidated income statement for the year ended 31 December 2017

	Note	2017 £m	2016 £m	2015 £m
Interest receivable		11,034	11,258	11,925
Interest payable		(2,047)	(2,550)	(3,158)
Net interest income	1	8,987	8,708	8,767
Fees and commissions receivable		3,338	3,340	3,742
Fees and commissions payable		(883)	(805)	(809)
Income from trading activities		634	974	1,060
Loss on redemption of own debt		(7)	(126)	(263)
Other operating income		1,064	499	426
Non-interest income	2	4,146	3,882	4,156
Total income		13,133	12,590	12,923
Staff costs		(4,676)	(5,124)	(5,726)
Premises and equipment		(1,565)	(1,388)	(1,827)
Other administrative expenses		(3,323)	(8,745)	(6,288)
Depreciation and amortisation		(808)	(778)	(1,180)
Write down of goodwill and other intangible assets		(29)	(159)	(1,332)
Operating expenses	3	(10,401)	(16,194)	(16,353)
Profit/(loss) before impairment (losses)/releases		2,732	(3,604)	(3,430)
Impairment (losses)/releases	11	(493)	(478)	727
Operating profit/(loss) before tax		2,239	(4,082)	(2,703)
Tax charge	6	(824)	(1,166)	(23)
Profit/(loss) from continuing operations		1,415	(5,248)	(2,726)
Profit from discontinued operations, net of tax	18			1,541
Profit/(loss) for the year		1,415	(5,248)	(1,185)
Attributable to:				
Non-controlling interests		35	10	409
Preference shareholders		234	260	297
Paid-in equity holders		394	244	88
Dividend access share	7		1,193	
Ordinary shareholders		752	(6,955)	(1,979)
		1,415	(5,248)	(1,185)
Per ordinary share				
Basic and diluted earnings/(loss) from continuing and discontinued operations	7	6.3p	(59.5p)	(27.7p)
Basic and diluted earnings/(loss) from continuing operations	7	6.3p	(59.5p)	(17.2p)

The accompanying notes on pages 255 to 331, the accounting policies on pages 242 to 254 and the audited sections of the Business review: Capital and risk management on pages 151 to 230 form an integral part of these financial statements.

Consolidated statement of comprehensive income for the year ended 31 December 2017

	Note	2017 £m	2016 £m	2015 £m
Profit/(loss) for the year		1,415	(5,248)	(1,185)
Items that do not qualify for reclassification				
Profit/(loss) on remeasurement of retirement benefit schemes	4	90	(1,049)	(73)
Loss on fair value of credit in financial liabilities designated at fair value through profit or loss due to own credit risk		(126)		
Tax		(10)	288	306
		(46)	(761)	233
Items that do qualify for reclassification				
Available-for-sale financial assets		26	(94)	44
Cash flow hedges		(1,069)	765	(700)
Currency translation		100	1,263	(1,181)
Tax		256	(106)	108
		(687)	1,828	(1,729)
Other comprehensive (loss)/income after tax		(733)	1,067	(1,496)
Total comprehensive income/(loss) for the year		682	(4,181)	(2,681)
Attributable to:				
Non-controlling interests		52	121	370
Preference shareholders		234	260	297
Paid-in equity holders		394	244	88
Dividend access share			1,193	
Ordinary shareholders		2	(5,999)	(3,436)
		682	(4,181)	(2,681)

The accompanying notes on pages 255 to 331, the accounting policies on pages 242 to 254 and the audited sections of the Business review: Capital and risk management on pages 151 to 230 form an integral part of these financial statements.

Consolidated balance sheet as at 31 December 2017

	Note	2017 £m	2016 £m
Assets			
Cash and balances at central banks	8	98,337	74,250
Loans and advances to banks	8	30,251	30,138
Loans and advances to customers	8	349,919	351,950
Debt securities subject to repurchase agreements	29	23,781	18,107
Other debt securities		55,152	54,415
Debt securities	13	78,933	72,522
Equity shares	14	450	703
Settlement balances		2,517	5,526
Derivatives	12	160,843	246,981
Intangible assets	15	6,543	6,480
Property, plant and equipment	16	4,602	4,590
Deferred tax	22	1,740	1,803
Prepayments, accrued income and other assets	17	3,726	3,700
Assets of disposal groups	18	195	13
Total assets		738,056	798,656
Liabilities			
Deposits by banks	8	46,898	38,556
Customer accounts	8	398,036	380,968
Debt securities in issue	8	30,559	27,245
Settlement balances		2,844	3,645
Short positions	19	28,527	22,077
Derivatives	12	154,506	236,475
Provisions for liabilities and charges	20	7,757	12,836
Accruals and other liabilities	21	6,392	6,991
Retirement benefit liabilities	4	129	363
Deferred tax	22	583	662
Subordinated liabilities	23	12,722	19,419
Liabilities of disposal groups	18	10	15
Total liabilities		688,963	749,252
Non-controlling interests	24	763	795
Owners' equity	25, 26	48,330	48,609
Total equity		49,093	49,404
Total liabilities and equity		738,056	798,656

The accompanying notes on pages 255 to 331, the accounting policies on pages 242 to 254 and the audited sections of the Business review: Capital and risk management on pages 151 to 230 form an integral part of these financial statements.

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The accounts were approved by the Board of directors on 22 February 2018 and signed on its behalf by:

Howard Davies
Chairman

Ross McEwan
Chief Executive

Ewen Stevenson
Chief Financial Officer

The Royal Bank of Scotland Group plc
Registered No. SC45551

Consolidated statement of changes in equity for the year ended 31 December 2017

	2017 £m	2016 £m	2015 £m
Called-up share capital			
At 1 January	11,823	11,625	6,877
Ordinary shares issued	142	198	159
Conversion of B shares (1)			4,590
Preference shares redeemed (2)			(1)
At 31 December	11,965	11,823	11,625
Paid-in equity			
At 1 January	4,582	2,646	784
Redeemed/reclassified (3)	(524)	(110)	(150)
Additional Tier 1 capital notes issued (4)		2,046	2,012
At 31 December	4,058	4,582	2,646
Share premium account			
At 1 January	25,693	25,425	25,052
Ordinary shares issued	235	268	373
Redemption of debt preference shares (2)	748		
Capital reduction (5)	(25,789)		
At 31 December	887	25,693	25,425
Merger reserve			
At 1 January	10,881	10,881	13,222
Transfer to retained earnings			(2,341)
At 31 December	10,881	10,881	10,881
Available-for-sale reserve			
At 1 January	238	307	299
Unrealised gains	202	282	31
Realised (gains)/losses	(176)	(376)	27
Tax	(9)	25	(16)
Recycled to profit or loss on ceding control of Citizens (6)			9
Transfer to retained earnings			(43)
At 31 December	255	238	307
Cash flow hedging reserve			
At 1 January	1,030	458	1,029
Amount recognised in equity	(277)	1,867	712
Amount transferred from equity to earnings	(792)	(1,102)	(1,354)
Tax	266	(193)	98
Recycled to profit or loss on ceding control of Citizens (7)			(36)
Transfer to retained earnings			9
At 31 December	227	1,030	458
Foreign exchange reserve			
At 1 January	2,888	1,674	3,483

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Retranslation of net assets	111	1,470	(22)
Foreign currency losses on hedges of net assets	(6)	(278)	(176)
Tax	(1)	62	(11)
Recycled to profit or loss on disposal of businesses (8)	(22)	(40)	4
Recycled to profit or loss on ceding control of Citizens (8)			(962)
Transfer to retained earnings			(642)
At 31 December	2,970	2,888	1,674
Capital redemption reserve			
At 1 January	4,542	4,542	9,131
Conversion of B shares (1)			(4,590)
Capital reduction (5)	(4,542)		
Preference shares redeemed (2)			1
At 31 December		4,542	4,542

For notes to these tables see page 240.

Consolidated statement of changes in equity for the year ended 31 December 2017

	2017 £m	2016 £m	2015 £m
Retained earnings			
At 1 January	(12,936)	(4,020)	(4,001)
Profit/(loss) attributable to ordinary shareholders and other equity owners			
- continuing operations	1,380	(5,258)	(2,801)
- discontinued operations			1,207
Equity preference dividends paid	(234)	(260)	(297)
Paid-in equity dividends paid, net of tax	(394)	(244)	(88)
Capital reduction (5)	30,331		
Dividend access share dividend		(1,193)	
Transfer from available-for-sale reserve			43
Transfer from cash flow hedging reserve			(9)
Transfer from foreign exchange reserve			642
Transfer from merger reserve			2,341
Costs of placing Citizens equity			(29)
Redemption of debt preference shares (2)	(748)		
Redemption of equity preference shares (2)		(1,160)	(1,214)
Redemption/reclassification of paid-in equity	(196)	(21)	(27)
Gain/(loss) on remeasurement of the retirement benefit schemes			
- gross	90	(1,049)	(67)
- tax	(28)	288	306
Changes in fair value of credit in financial liabilities designated at fair value through profit or loss			
- gross	(126)		
- tax	18		
Shares issued under employee share schemes	(5)	(10)	(58)
Share-based payments			
- gross	(22)	(9)	36
- tax			(4)
At 31 December	17,130	(12,936)	(4,020)
Own shares held			
At 1 January	(132)	(107)	(113)
Disposal of own shares			6
Shares issued under employee share schemes	161	41	
Own shares acquired	(72)	(66)	
At 31 December	(43)	(132)	(107)
Owners equity at 31 December	48,330	48,609	53,431

For notes to these tables refer to the following page.

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The accompanying notes on pages 255 to 331, the accounting policies on pages 242 to 254 and the audited sections of the Business review: Capital and risk management on pages 151 to 230 form an integral part of these financial statements.

Consolidated statement of changes in equity for the year ended 31 December 2017

	2017 £m	2016 £m	2015 £m
Non-controlling interests (see Note 24)			
At 1 January	795	716	2,946
Currency translation adjustments and other movements	17	111	3
Profit attributable to non-controlling interests			
- continuing operations	35	10	75
- discontinued operations			334
Dividends paid	(25)		(31)
Movements in available-for-sale securities			
- unrealised gains			22
- realised gains			(6)
- tax			(5)
Movements in cash flow hedging reserve			
- amount recognised in equity			32
- tax			(4)
Loss on remeasurement of the retirement benefit schemes			
- gross			(6)
Equity raised (9)			2,537
Equity withdrawn and disposals	(59)	(42)	(24)
Loss of control of Citizens			(5,157)
At 31 December	763	795	716
Total equity at 31 December	49,093	49,404	54,147
Total equity is attributable to:			
Non-controlling interests	763	795	716
Preference shareholders	2,565	2,565	3,305
Paid-in equity holders	4,058	4,582	2,646
Ordinary shareholders	41,707	41,462	47,480
	49,093	49,404	54,147

Notes:

- (1) In October 2015, all B shares were converted into ordinary shares of £1 each.
- (2) During 2017, non-cumulative US dollar preference shares were redeemed at their original issue price of US\$1.1 billion. The nominal value of £0.3 million has been credited to the capital redemption reserve; share premium increased by £0.7 billion in respect of the premium received on issue, with a corresponding decrease in retained earnings. During 2016, non-cumulative US dollar preference shares were redeemed at their original issue price of US\$1.5 billion (2015 - \$1.9 billion). The nominal value of £0.3 million (2015 - £1.0 million) was transferred from share capital to capital redemption reserve and ordinary owners equity was reduced by £0.4 billion (2015 - £0.2 billion) in respect of the movement in exchange rates since issue.

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- (3) Paid-in equity reclassified to liabilities as a result of the call of US\$564 million and CAD321 million EMTN notes in August 2017 (redeemed in October 2017), the call of RBS Capital Trust D in March 2017 (redeemed in June 2017), the call of RBS Capital Trust C in May 2016 (redeemed in July 2016), the call of RBS Capital Trust IV in January 2015 (redeemed in March 2015).
- (4) AT1 capital notes totalling £2.0 billion issued in August 2016 (2015 - £2.0 billion).
- (5) On 15 June 2017, the Court of Session approved a reduction of RBSG plc capital so that the amounts which stood to the credit of share premium, account and capital redemption reserve were transferred to retained earnings.
- (6) 2015 Net of tax - £6 million charge.
- (7) 2015 Net of tax - £16 million credit.
- (8) No tax impact.
- (9) Includes £2,491 million relating to the secondary offering of Citizens in March 2015.

The accompanying notes on pages 255 to 331, the accounting policies on pages 242 to 254 and the audited sections of the Business review: Capital and risk management on pages 151 to 230 form an integral part of these financial statements.

Consolidated cash flow statement for the year ended 31 December 2017

	Note	2017 £m	2016 £m	2015 £m
Cash flows from operating activities				
Operating profit/(loss) before tax from continuing operations		2,239	(4,082)	(2,703)
Profit before tax from discontinued operations				1,766
Adjustments for non-cash items and other adjustments included within income statement		(4,498)	(3,024)	(5,601)
Contributions to defined benefit schemes		(627)	(4,786)	(1,060)
Changes in operating assets and liabilities		42,147	8,413	8,589
Income taxes paid		(520)	(171)	(73)
Net cash flows from operating activities	32	38,741	(3,650)	918
Cash flows from investing activities				
Sale and maturity of securities		11,656	8,599	8,229
Purchase of securities		(17,212)	(11,607)	(14,135)
Sale of property, plant and equipment		405	447	1,432
Purchase of property, plant and equipment		(1,132)	(912)	(783)
Net divestment of/(investment in) business interests and intangible assets	33	(199)	(886)	391
Net cash flows from investing activities		(6,482)	(4,359)	(4,866)
Cash flows from financing activities				
Issue of ordinary shares		306	300	307
Issue of Additional Tier 1 capital notes			2,046	2,012
Redemption of non-controlling interests				2,537
Redemption of paid-in equity		(720)	(110)	(150)
Redemption of equity preference shares			(1,160)	(1,214)
Redemption of debt preference shares		(748)		
Non-controlling interests equity withdrawn and disposals		(59)	(42)	
Own shares (acquired)/disposed		89	(25)	6
Redemption of subordinated liabilities		(5,747)	(3,606)	(3,047)
Dividends paid		(612)	(504)	(416)
Dividend access share			(1,193)	
Interest on subordinated liabilities		(717)	(813)	(975)
Net cash flows from financing activities		(8,208)	(5,107)	(940)
Effects of exchange rate changes on cash and cash equivalents		(16)	8,094	576
Net increase/(decrease) in cash and cash equivalents		24,035	(5,022)	(4,312)
Cash and cash equivalents at 1 January		98,570	103,592	107,904
Cash and cash equivalents at 31 December	36	122,605	98,570	103,592

The accompanying notes on pages 255 to 331, the accounting policies on pages 242 to 254 and the audited sections of the Business review: Capital and risk management on pages 151 to 230 form an integral part of these financial statements.

Accounting policies

1. Presentation of accounts

The accounts, set out on pages 231 to 331 including these accounting policies on pages 242 to 254 and the audited sections of the Financial review: Capital and risk management on pages 151 to 230, are prepared on a going concern basis (see the Report of the directors, page 108) and in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) and interpretations issued by the IFRS Interpretations Committee of the IASB as adopted by the European Union (EU) (together IFRS). The EU has not adopted the complete text of IAS 39 Financial Instruments: Recognition and Measurement ; it has relaxed some of the standard's hedging requirements. The Group has not taken advantage of this relaxation: its financial statements are prepared in accordance with IFRS as issued by the IASB.

The company is incorporated in the UK and registered in Scotland. Its accounts are presented in accordance with the Companies Act 2006. With the exception of investment property and certain financial instruments as described in Accounting policies 9, 14, 16 and 23, the accounts are presented on an historical cost basis.

The Group adopted two revisions to IFRSs effective 1 January 2017:

In January 2016, the IASB amended IAS 7 Cash Flow Statements to require disclosure of the movements in financing liabilities. This is shown in Note 35.

In January 2016, the IASB amended IAS 12 Income taxes to clarify the recognition of deferred tax assets in respect of unrealised losses.

Neither of these amendments has had a material effect on the Group's financial statements.

2. Basis of consolidation

The consolidated accounts incorporate the financial statements of the company and entities (including certain structured entities) that are controlled by the Group. The Group controls another entity (a subsidiary) when it is exposed, or has rights, to variable returns from its involvement with that entity and has the ability to affect those returns through its power over the other entity; power generally arises from holding a majority of voting rights. On acquisition of a subsidiary, its identifiable assets, liabilities and contingent liabilities are included in the consolidated accounts at their fair value. A subsidiary is included in the consolidated financial statements from the date it is controlled by the Group until the date the Group ceases to control it through a sale or a significant change in circumstances. Changes in the Group's interest in a subsidiary that do not result in the Group ceasing to control that subsidiary are accounted for as equity transactions.

All intergroup balances, transactions, income and expenses are eliminated on consolidation. The consolidated accounts are prepared under uniform accounting policies.

3. Revenue recognition

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

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.

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

Payment services - this comprises income received for payment services including cheques cashed, direct debits, Clearing House Automated Payments (the UK electronic settlement system) and BACS payments (the automated clearing house that processes direct debits and direct credits). These are generally charged on a per transaction basis. The income is earned when the payment or transaction occurs. Charges for payment services are usually debited to the customer's account monthly or quarterly in arrears. Income is accrued at period end for services provided but not yet charged.

Credit and debit card fees - fees from card business include:

- 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.
- Periodic fees payable by a credit card or debit card holder are deferred and taken to profit or loss over the period of the service.

Lending (credit facilities) - 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 loan.

Accounting policies

Brokerage fees - in respect of securities, foreign exchange, futures or options transactions entered into on behalf of a customer are recognised as income on execution of a significant act.

Trade finance - income from the provision of trade finance is recognised over the term of the finance unless specifically related to a significant act, in which case income is recognised when the act is executed.

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

4. Assets held for sale and discontinued operations

A non-current asset (or disposal group) is classified as held for sale if the Group will recover its carrying amount principally through a sale transaction rather than through continuing use. A non-current asset (or disposal group) classified as held for sale is measured at the lower of its carrying amount and fair value less costs to sell. If the asset (or disposal group) is acquired as part of a business combination it is initially measured at fair value less costs to sell. Assets and liabilities of disposal groups classified as held for sale and non-current assets classified as held for sale are shown separately on the face of the balance sheet.

The results of discontinued operations, comprising the post-tax profit or loss of discontinued operations and the post-tax gain or loss recognised either on measurement to fair value less costs to sell or on disposal of the discontinued operation, are shown as a single amount on the face of the income statement; an analysis of this amount is presented in Note 18 on the accounts.

A discontinued operation is a cash generating unit or a group of cash generating units that either has been disposed of, or is classified as held for sale, and (a) represents a separate major line of business or geographical area of operations, (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or (c) is a subsidiary acquired exclusively with a view to resale.

5. Employee benefits

Short-term employee benefits, such as salaries, paid absences, and other benefits are accounted for on an accruals basis over the period in which the employees provide the related services. Employees may receive variable compensation satisfied by cash, by debt instruments issued by the Group or by RBSG shares. The treatment of share-based compensation is set out in Accounting policy 25. Variable compensation that is settled in cash or debt instruments is charged to profit or loss over the period from the start of the year to which the variable compensation relates to the expected settlement date taking account of forfeiture and clawback criteria.

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Contributions to defined contribution pension schemes are recognised in profit or loss when payable.

For defined benefit schemes, the defined benefit obligation is measured on an actuarial basis using the projected unit credit method and discounted at a rate determined by reference to market yields at the end of the reporting period on high quality corporate bonds of equivalent term and currency to the scheme liabilities. Scheme assets are measured at their fair value. The difference between scheme assets and scheme liabilities, the net defined benefit asset or liability, is recognised in the balance sheet. A defined benefit asset is limited to the present value of any economic benefits available to the Group in the form of refunds from the plan or reduced contributions to it.

The charge to profit or loss for pension costs (recorded in operating expenses) comprises:

- the current service cost
- interest, computed at the rate used to discount scheme liabilities, on the net defined benefit liability or asset
- past service cost resulting from a scheme amendment or curtailment
- gains or losses on settlement.

A curtailment occurs when the Group significantly reduces the number of employees covered by a plan. A plan amendment occurs when the Group introduces, or withdraws, a defined benefit plan or changes the benefits payable under an existing defined benefit plan. Past service cost may be either positive (when benefits are introduced or changed so that the present value of the defined benefit obligation increases) or negative (when benefits are withdrawn or changed so that the present value of the defined benefit obligation decreases). A settlement is a transaction that eliminates all further obligation for part or all of the benefits.

Actuarial gains and losses (i.e. gains or and losses on re-measuring the net defined benefit asset or liability) are recognised in other comprehensive income in full in the period in which they arise.

6. Intangible assets and goodwill

Intangible assets acquired by the Group are stated at cost less accumulated amortisation and impairment losses. Amortisation is charged to profit or loss over the assets' estimated economic lives using methods that best reflect the pattern of economic benefits and is included in Depreciation and amortisation. These estimated useful economic lives are:

Computer software	3 to 12 years
Other acquired intangibles	5 to 10 years

Expenditure on internally generated goodwill and brands is written-off as incurred. Direct costs relating to the development of internal-use computer software are capitalised once technical feasibility and economic viability have been established. These costs include payroll, the costs of materials and services, and directly attributable overheads. Capitalisation of costs ceases when the software is capable of operating as intended.

Accounting policies

During and after development, accumulated costs are reviewed for impairment against the benefits that the software is expected to generate. Costs incurred prior to the establishment of technical feasibility and economic viability are expensed as incurred as are all training costs and general overheads. The costs of licences to use computer software that are expected to generate economic benefits beyond one year are also capitalised.

Intangible assets include goodwill arising on the acquisition of subsidiaries and joint ventures. Goodwill on the acquisition of a subsidiary is the excess of the fair value of the consideration transferred, the fair value of any existing interest in the subsidiary and the amount of any non-controlling interest measured either at fair value or at its share of the subsidiary's net assets over net fair value of the subsidiary's identifiable assets, liabilities and contingent liabilities.

Goodwill arises on the acquisition of a joint venture when the cost of investment exceeds the Group's share of the net fair value of the joint venture's identifiable assets and liabilities. Goodwill is measured at initial cost less any subsequent impairment losses. Goodwill arising on the acquisition of associates is included within their carrying amounts. The gain or loss on the disposal of a subsidiary, associate or joint venture includes the carrying value of any related goodwill.

7. Property, plant and equipment

Items of property, plant and equipment (except investment property - see Accounting policy 9) are stated at cost less accumulated depreciation and impairment losses. Where an item of property, plant and equipment comprises major components having different useful lives, these are accounted for separately.

Depreciation is charged to profit or loss on a straight-line basis so as to write-off the depreciable amount of property, plant and equipment (including assets owned and let on operating leases) over their estimated useful lives. The depreciable amount is the cost of an asset less its residual value. Freehold land is not depreciated. The estimated useful lives of the Group's property, plant and equipment are:

Freehold buildings	50 years
Long leasehold property (leases with more than 50 years to run)	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

The residual value and useful life of property, plant and equipment are reviewed at each balance sheet date and updated for any changes to previous estimates.

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

At each balance sheet 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, the recoverable amount is determined for the cash-generating unit to which the asset belongs. A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. For the purposes of impairment testing, goodwill acquired in a business combination is allocated to each of the Group's cash-generating units or groups of cash-generating units expected to benefit from the combination. The recoverable amount of an asset or cash-generating unit is the higher of its fair value less cost to sell and its value in use. Value in use is the present value of future cash flows from the asset or cash-generating unit discounted at a rate that reflects market interest rates adjusted for risks specific to the asset or cash-generating unit that have not been taken into account in estimating 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 can be recognised when an increase in service potential arises provided the increased carrying value is not greater than it would have been had no impairment loss been recognised. Impairment losses on goodwill are not reversed.

9. Investment property

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

10. Foreign currencies

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

Group entities record transactions in foreign currencies in their functional currency, the currency of the primary economic environment in which they operate, at the foreign exchange rate ruling at the date of the transaction.

Accounting policies

Monetary assets and liabilities denominated in foreign currencies are translated into the relevant functional currency at the foreign exchange rates ruling at the balance sheet date. Foreign exchange differences arising on the settlement of foreign currency transactions and from the translation of monetary assets and liabilities are reported in income from trading activities except for differences arising on cash flow hedges and hedges of net investments in foreign operations (see Accounting policy 23). Non-monetary items denominated in foreign currencies that are stated at fair value are translated into the relevant functional currency at the foreign exchange rates ruling at the dates the values are 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 recognised in other comprehensive income unless the asset is the hedged item in a fair value hedge.

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. Income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions. Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income. The amount accumulated in equity is reclassified from equity to profit or loss on disposal of a foreign operation.

11. Leases

As lessor

Contracts with customers 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; all other contracts with customers to lease assets are classified as operating leases.

Finance lease receivables are included in the balance sheet, within Loans and advances to customers, 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 and included in Interest receivable. Unguaranteed residual values are subject to regular review; if there is a reduction in their value, income allocation is revised and any reduction in respect of amounts accrued is recognised immediately.

Rental income from operating leases is recognised in income on a straight-line basis over the lease term unless another systematic basis better represents the time pattern of the asset's use. Operating lease assets are included within Property, plant and equipment and depreciated over their useful lives (see Accounting policy 7). Operating lease rentals receivable are included in Other operating income.

As lessee

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The Group's contracts to lease assets are principally operating leases. Operating lease rental expense is included in Premises and equipment costs and recognised as an expense on a straight-line basis over the lease term unless another systematic basis better represents the benefit to the Group.

12. Provisions

The Group recognises a provision for a present obligation resulting from a past event when it is more likely than not that it will be required to transfer economic benefits to settle the obligation and the amount of the obligation can be estimated reliably.

Provision is made for restructuring costs, including the costs of redundancy, when the Group has a constructive obligation to restructure. An obligation exists when the Group has a detailed formal plan for the restructuring and has raised a valid expectation in those affected by starting to implement the plan or by announcing its main features.

If the Group has a contract that is onerous, it recognises the present obligation under the contract as a provision. An onerous contract is one where the unavoidable costs of meeting the Group's contractual obligations exceed the expected economic benefits. When the Group vacates a leasehold property, a provision is recognised for the costs under the lease less any expected economic benefits (such as rental income).

Contingent liabilities are possible obligations arising from past events, whose existence will be confirmed only by uncertain future events, or present obligations arising from past events that are not recognised because either an outflow of economic benefits is not probable or the amount of the obligation cannot be reliably measured. Contingent liabilities are not recognised but information about them is disclosed unless the possibility of any outflow of economic benefits in settlement is remote.

13. Tax

Income tax expense or income, comprising current tax and deferred tax, is recorded in the income statement except income tax on items recognised outside profit or loss which is credited or charged to other comprehensive income or to equity as appropriate.

Current tax is income tax payable or recoverable in respect of the taxable profit or loss for the year arising in profit or loss, other comprehensive income or equity. Provision is made for current tax at rates enacted or substantively enacted at the balance sheet date.

Deferred tax is the tax expected to be payable or recoverable in respect of temporary differences between the carrying amount of an asset or liability for accounting purposes and its carrying amount for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised.

Accounting policies

Deferred tax is not recognised on temporary differences that arise from initial recognition of an asset or a liability in a transaction (other than a business combination) that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax is calculated using tax rates expected to apply in the periods when the assets will be realised or the liabilities settled, based on tax rates and laws enacted, or substantively enacted, at the balance sheet date.

Deferred tax assets and liabilities are offset where the Group has a legally enforceable right to offset and where they relate to income taxes levied by the same taxation authority either on an individual Group company or on Group companies in the same tax group that intend, in future periods, to settle current tax liabilities and assets on a net basis or on a gross basis simultaneously.

14. Financial assets

On initial recognition, financial assets are classified into held-to-maturity investments; held-for-trading; designated as at fair value through profit or loss; loans and receivables; or available-for-sale financial assets. Normal purchases of financial assets classified as loans and receivables are recognised on the settlement date; all other normal transactions in financial assets are recognised on the trade date.

Held-to-maturity investments - a financial asset may be classified as a held-to-maturity investment only if it has fixed or determinable payments, a fixed maturity and the Group has the positive intention and ability to hold to maturity. Held-to-maturity investments are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at amortised cost using the effective interest method (see Accounting policy 3) less any impairment losses.

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

Designated as at fair value through profit or loss - financial assets may be designated as at fair value through profit or loss only if such designation (a) eliminates or significantly reduces a measurement or recognition inconsistency; or (b) applies to a group of financial assets, financial liabilities or both, that the Group manages and evaluates on a fair value basis; or (c) relates to an instrument that contains an embedded derivative which is not evidently closely related to the host contract. Financial assets that the Group designates on initial recognition as being at fair value through profit or loss are recognised at fair value, with transaction costs being recognised in profit or loss, and are subsequently measured at fair value. Gains and losses are recognised in profit or loss as they arise.

Loans and receivables - non-derivative financial assets with fixed or determinable repayments that are not quoted in an active market are classified as loans and receivables, except those that are classified as available-for-sale or as held-for-trading, or designated as at fair value through profit or

loss. Loans and receivables are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at amortised cost using the effective interest method (see Accounting policy 3) less any impairment losses.

Available-for-sale financial assets - financial assets that are not classified as held-to-maturity; held-for-trading; designated as at fair value through profit or loss; or loans and receivables are classified as available-for-sale. Financial assets can be designated as available-for-sale on initial recognition. Available-for-sale financial assets are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at fair value. Unquoted equity investments whose fair value cannot be measured reliably are carried at cost and classified as available-for-sale financial assets. Impairment losses and exchange differences resulting from retranslating the amortised cost of foreign currency monetary available-for-sale financial assets are recognised in profit or loss together with interest calculated using the effective interest method (see Accounting policy 3) as are gains and losses attributable to the hedged risk on available-for-sale financial assets that are hedged items in fair value hedges (see Accounting policy 23). Other changes in the fair value of available-for-sale financial assets and any related tax are reported in other comprehensive income until disposal, when the cumulative gain or loss is reclassified from equity to profit or loss.

Reclassifications - held-for-trading and available-for-sale financial assets that meet the definition of loans and receivables (non-derivative financial assets with fixed or determinable payments that are not quoted in an active market) may be reclassified to loans and receivables if the Group has the intention and ability to hold the financial asset for the foreseeable future or until maturity. The Group typically regards the foreseeable future for this purpose as twelve months from the date of reclassification. Additionally, held-for-trading financial assets that do not meet the definition of loans and receivables may, in rare circumstances, be transferred to available-for-sale financial assets or to held-to-maturity investments. Reclassifications are made at fair value. This fair value becomes the asset's new cost or amortised cost as appropriate. Gains and losses recognised up to the date of reclassification are not reversed.

Fair value - the Group's approach to determining the fair value of financial instruments measured at fair value is set out in the section of Critical accounting policies and key sources of estimation uncertainty entitled Fair value - financial instruments. Further details are given in Note 9 on the accounts.

15. Impairment of financial assets

The Group assesses at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets classified as held-to-maturity, as available-for-sale or as loans and receivables is impaired.

Accounting policies

A financial asset or group of financial assets is impaired and an impairment loss incurred if there is objective evidence that an event or events since initial recognition of the asset have adversely affected the amount or timing of future cash flows from the asset.

Financial assets carried at amortised cost - if there is objective evidence that an impairment loss on a financial asset or group of financial assets classified as loans and receivables or as held-to-maturity investments has been incurred, the Group measures the amount of the loss as the difference between the carrying amount of the asset or group of assets and the present value of estimated future cash flows from the asset or group of assets discounted at the effective interest rate of the instrument at initial recognition. For collateralised loans and receivables, estimated future cash flows include cash flows that may result from foreclosure less the costs of obtaining and selling the collateral, whether or not foreclosure is probable.

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

Impairment losses are assessed individually for financial assets that are individually significant and individually or collectively for assets that are not individually significant. In making collective impairment assessments, financial assets are grouped into portfolios on the basis of similar risk characteristics. Future cash flows from these portfolios are estimated on the basis of the contractual cash flows and historical loss experience for assets with similar credit risk characteristics. Historical loss experience is adjusted, on the basis of observable data, to reflect current conditions not affecting the period of historical experience. Impairment losses are recognised in profit or loss and the carrying amount of the financial asset or group of financial assets reduced by establishing an allowance for impairment losses. If, in a subsequent period, the amount of the impairment loss reduces and the reduction can be ascribed to an event after the impairment was recognised, the previously recognised loss is reversed by adjusting the allowance. Once an impairment loss has been recognised on a financial asset or group of financial assets, interest income is recognised on the carrying amount using the rate of interest at which estimated future cash flows were discounted in measuring impairment.

Impaired loans and receivables are written off, i.e. the impairment provision is applied in writing down the loan's carrying value partially or in full, when the Group concludes that there is no longer any realistic prospect of recovery of part or all of the loan. For loans that are individually assessed for impairment, the timing of write off is determined on a case-by-case basis. Such loans are reviewed regularly and write off will be prompted by bankruptcy, insolvency, renegotiation and similar events.

The typical time frames from initial impairment to write off for the Group's collectively-assessed portfolios are:

- Retail mortgages: write off usually occurs within five years, or when an account is closed if earlier.
- Credit cards: the irrecoverable amount is written off after 12 months; three years later any remaining amounts outstanding are written off.

- Overdrafts and other unsecured loans: write off occurs within six years.
- Business and commercial loans: write offs of commercial loans are determined in the light of individual circumstances; the period does not exceed five years. Business loans are generally written off within five years.

Amounts recovered after a loan has been written off are credited to the loan impairment charge for the period in which they are received.

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

16. Financial liabilities

Financial liabilities are recognised initially at fair value and classified into held-for-trading; designated as at fair value through profit or loss; or amortised cost. Issues of financial liabilities measured at amortised cost are recognised on settlement date; all other normal transactions in financial liabilities are recognised on trade date.

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

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

Accounting policies

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. Income from trading activities includes gains and losses on held-for-trading financial liabilities as they arise.

Financial liabilities designated as at fair value through profit or loss principally comprise structured liabilities issued by the Group: designation significantly reduces the measurement inconsistency between these liabilities and the related derivatives carried at fair value.

Amortised cost - all other financial liabilities are measured at amortised cost using the effective interest method (see Accounting policy 3).

Fair value - the Group's approach to determining the fair value of financial instruments measured at fair value is set out in the section of Critical accounting policies and key sources of estimation uncertainty entitled Fair value - financial instruments; further details are given in Note 9 on the accounts.

17. Financial guarantee contracts

Under a financial guarantee contract, the Group, in return for a fee, undertakes to meet a customer's obligations under the terms of a debt instrument if the customer fails to do so. A financial guarantee is recognised as a liability; initially at fair value and, if not designated as at fair value through profit or loss, subsequently at the higher of its initial value less cumulative amortisation and any provision under the contract measured in accordance with Accounting policy 12. Amortisation is calculated so as to recognise fees receivable in profit or loss over the period of the guarantee.

18. Loan commitments

Provision is made for loan commitments, other than those classified as held-for-trading, if it is probable that the facility will be drawn and the resulting loan will be recognised at an amount less than the cash advanced. Syndicated loan commitments in excess of the level of lending under the commitment approved for retention by the Group are classified as held-for-trading and measured at fair value.

19. Derecognition

A financial asset is derecognised when the contractual right to receive cash flows from the asset has expired or 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. The asset remains on the balance sheet if substantially all the risks and rewards have been retained. It is derecognised if substantially all the risks and rewards have been transferred.

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 the Group has retained control of the asset, it continues to recognise the asset to the extent of its continuing involvement; if the Group has not retained control of the asset, it is derecognised.

A financial liability is removed from the balance sheet when the obligation is discharged, or is cancelled, or expires. On the redemption or settlement of debt securities (including subordinated liabilities) issued by the Group, the Group derecognises the debt instrument and records a gain or loss being the difference between the debt's carrying amount and the cost of redemption or settlement. The same treatment applies where the debt is exchanged for a new debt issue that has terms substantially different from those of the existing debt. The assessment of whether the terms of the new debt instrument are substantially different takes into account qualitative and quantitative characteristics including a comparison of the present value of the cash flows under the new terms with the present value of the remaining cash flows of the original debt issue discounted at the effective interest rate of the original debt issue.

20. Sale and repurchase transactions

Securities subject to a sale and repurchase agreement under which substantially all the risks and rewards of ownership are retained by the Group continue to be shown on the balance sheet and the sale proceeds recorded as a financial liability. Securities acquired in a reverse sale and repurchase transaction under which the Group is not exposed to substantially all the risks and rewards of ownership are not recognised on the balance sheet and the consideration paid is recorded as a financial asset.

Securities borrowing and lending transactions are usually secured by cash or securities advanced by the borrower. Borrowed securities are not recognised on the balance sheet or lent securities derecognised.

Cash collateral given or received is treated as a loan or deposit; collateral in the form of securities is not recognised. However, where securities borrowed are transferred to third parties, a liability for the obligation to return the securities to the stock lending counterparty is recorded.

21. Netting

Financial assets and financial liabilities are offset and the net amount presented in the balance sheet when, and only when, the Group currently has a legally enforceable right to set off the recognised amounts and it intends either to settle on a net basis or to realise the asset and settle the liability simultaneously. The Group is party to a number of arrangements, including master netting agreements, that give it the right to offset financial assets and financial liabilities, but where it does not intend to settle the amounts net or simultaneously, the assets and liabilities concerned are presented gross.

Accounting policies

22. Capital instruments

The Group classifies a financial instrument that it issues 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 and 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.

Incremental costs and related tax that are directly attributable to an equity transaction are deducted from equity.

The consideration for any ordinary shares of the company purchased by the Group (treasury shares) is deducted from equity. On the cancellation of treasury shares their nominal value is removed from equity and any excess of consideration over nominal value is treated in accordance with the capital maintenance provisions of the Companies Act. On the sale or reissue of treasury shares the consideration received and related tax are credited to equity, net of any directly attributable incremental costs.

23. Derivatives and hedging

Derivative financial instruments are initially recognised, and subsequently measured, at fair value. The Group's approach to determining the fair value of financial instruments is set out in the section of Critical accounting policies and key sources of estimation uncertainty entitled Fair value - financial instruments; further details are given in Note 9 on the accounts.

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

Gains and losses arising from changes in the fair value of derivatives that are not the hedging instrument in a qualifying hedge are recognised as they arise in profit or loss. Gains and losses are recorded in Income from trading activities except for gains and losses on those derivatives that are managed together with financial instruments designated at fair value; these gains and losses are included in Other operating income. The Group enters into three types of hedge relationship: hedges of changes in the fair value of a recognised asset or liability or unrecognised firm commitment (fair value hedges); hedges of the variability in cash flows from a recognised asset or liability or a highly probable forecast transaction (cash flow hedges); and hedges of the net investment in a foreign operation.

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

Hedge accounting is also discontinued if the Group revokes the designation of a hedge relationship.

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, where the hedged item is measured at amortised cost, adjusts the carrying amount of the hedged item. Hedge accounting is discontinued if the hedge no longer meets the criteria for hedge accounting; or if the hedging instrument expires or is sold, terminated or exercised; or if hedge designation is revoked. If the hedged item is one for which the effective interest rate method is used, any cumulative adjustment is amortised to profit or loss over the life of the hedged item using a recalculated effective interest rate.

Cash flow hedge - in a cash flow hedge, the effective portion of the gain or loss on the hedging instrument is recognised in other comprehensive income and the ineffective portion in profit or loss. When the forecast transaction results in the recognition of a financial asset or financial liability, the cumulative gain or loss is reclassified from equity to profit or loss in the same periods in which the hedged forecast cash flows affect profit or loss. Otherwise the cumulative gain or loss is removed from equity and recognised in profit or loss at the same time as the hedged transaction. Hedge accounting is discontinued if the hedge no longer meets the criteria for hedge accounting; if the hedging instrument expires or is sold, terminated or exercised; if the forecast transaction is no longer expected to occur; or if hedge designation is revoked. On the discontinuance of hedge accounting (except where a forecast transaction is no longer expected to occur), the cumulative unrealised gain or loss is reclassified from equity to profit or loss when the hedged cash flows occur or, if the forecast transaction results in the recognition of a financial asset or financial liability, when the hedged forecast cash flows affect profit or loss. Where a forecast transaction is no longer expected to occur, the cumulative unrealised gain or loss is reclassified from equity to profit or loss immediately.

Hedge of net investment in a foreign operation - in the hedge of a net investment in a foreign operation, the portion of foreign exchange differences arising on the hedging instrument determined to be an effective hedge is recognised in other comprehensive income. Any ineffective portion is recognised in profit or loss. Non-derivative financial liabilities as well as derivatives may be the hedging instrument in a net investment hedge. On disposal or partial disposal of a foreign operation, the amount accumulated in equity is reclassified from equity to profit or loss.

24. Associates and joint ventures

An associate is an entity over which the Group has significant influence. A joint venture is one which it controls jointly with other parties. Investments in associates and interests in joint ventures are recognised using the equity method. They are stated initially at cost, including attributable goodwill, and subsequently adjusted for post-acquisition changes in the Group's share of net assets.

Accounting policies

25. Share-based compensation

The Group operates a number of share-based compensation schemes under which it awards RBSG shares and share options to its employees. Such awards are generally subject to vesting conditions: conditions that vary the amount of cash or shares to which an employee is entitled. Vesting conditions include service conditions (requiring the employee to complete a specified period of service) and performance conditions (requiring the employee to complete a specified period of service and specified performance targets to be met). Other conditions to which an award is subject are non-vesting conditions (such as a requirement to save throughout the vesting period). The cost of employee services received in exchange for an award of shares or share options granted is measured by reference to the fair value of the shares or share options on the date the award is granted and takes into account non-vesting conditions and market performance conditions (conditions related to the market price of RBSG shares): an award is treated as vesting irrespective of whether any market performance condition or non-vesting condition is met. The fair value of options granted is estimated using valuation techniques which incorporate exercise price, term, risk-free interest rates, the current share price and its expected volatility. The cost is expensed on a straight-line basis over the vesting period (the period during which all the specified vesting conditions must be satisfied) with a corresponding increase in equity in an equity-settled award, or a corresponding liability in a cash-settled award. The cost is adjusted for vesting conditions (other than market performance conditions) so as to reflect the number of shares or share options that actually vest.

If an award is modified, the original cost continues to be recognised as if there had been no modification. Where modification increases the fair value of the award, this increase is recognised as an expense over the modified vesting period. A new award of shares or share options is treated as the modification of a cancelled award if, on the date the new award is granted, the Group identifies them as replacing the cancelled award. The cancellation of an award through failure to meet non-vesting conditions triggers an immediate expense for any unrecognised element of the cost of an award.

26. Cash and cash equivalents

In the cash flow statement, cash and cash equivalents comprises cash and deposits with banks with an original maturity of less than three months 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.

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 Conceptual Framework for Financial Reporting. 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.

(i) Goodwill

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The Group capitalises goodwill arising on the acquisition of businesses, as discussed in Accounting policy 6. The carrying value of goodwill as at 31 December 2017 was £5,558 million (2016 - £5,558 million).

Goodwill is the excess of the cost of an acquired business over the fair value of its net assets. 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.

Impairment testing in accordance with Accounting policy 8 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 their separable assets. The sensitivity of the assessment to changes in assumptions is discussed in Note 15 on the accounts.

(ii) Provisions for liabilities

As set out in Note 20 on the accounts, at 31 December 2017 the Group recognised provisions for liabilities in respect of Payment Protection Insurance, £1,053 million (2016 - £1,253 million), other customer redress, £870 million (2016 - £1,105 million), residential mortgage backed securities, £3,243 million (2016 - £6,752 million), litigation and other regulatory proceedings, £641 million (2016 - £1,918 million) and property and other £1,950 million (2016 - £1,808 million).

Accounting policies

Provisions are liabilities of uncertain timing or amount, and are recognised when there is a present obligation as a result of a past event, the outflow of economic benefit is probable and the outflow can be estimated reliably. Judgement is involved in determining whether an obligation exists, and in estimating the probability, timing and amount of any outflows. Where the Group can look to another party such as an insurer to pay some or all of the expenditure required to settle a provision, any reimbursement is recognised when, and only when, it is virtually certain that it will be received.

Payment Protection Insurance - the Group has established a provision for redress payable in respect of the mis-selling of Payment Protection Insurance policies. The provision is management's best estimate of the anticipated costs of redress and related administration expenses. The determination of appropriate assumptions to underpin the provision requires significant judgement by management. The principal assumptions underlying the provision together with sensitivities to changes in those assumptions are given in Note 20 on the accounts.

Provisions for litigation - the Group and members of the Group are party to legal proceedings in the United Kingdom, the United States and other jurisdictions, arising out of their normal business operations. The measurement and recognition of liabilities in respect of litigation involves a high degree of management judgement. Before the existence of a present obligation as the result of a past event can be confirmed, numerous facts may need to be established, involving extensive and time-consuming discovery, and novel or unsettled legal questions addressed. Once it is determined there is an obligation, assessing the probability of economic outflows and estimating the amount of any liability can be very difficult. In many proceedings, it is not possible to determine whether any loss is probable or to estimate the amount of any loss. Furthermore, for an individual matter, there can be a wide range of possible outcomes and often it is not practicable to quantify a range of such outcomes. The Group's outstanding litigation is periodically assessed in consultation with external professional advisers, where appropriate, to determine the likelihood of the Group incurring a liability. A detailed description of the Group's material legal proceedings and a discussion of the nature of the associated uncertainties are given in Note 31 on the accounts.

Tax contingencies - determining the Group's income tax charge and its provisions for income taxes necessarily involves a significant degree of estimation and judgement. The tax treatment of some transactions is uncertain and tax computations are yet to be agreed with the tax authorities in a number of jurisdictions. The Group recognises anticipated tax liabilities based on all available evidence and, where appropriate, in the light of external advice. Any difference between the final outcome and the amounts provided will affect current and deferred income tax assets and liabilities in the period when the matter is resolved.

(iii) Deferred tax

The Group makes provision for deferred tax on temporary differences where tax recognition occurs at a different time from accounting recognition. Deferred tax assets of £1,740 million were recognised as at 31 December 2017 (2016 - £1,803 million).

The Group has recognised deferred tax assets in respect of losses, principally in the UK, and temporary differences. Deferred tax assets are recognised in respect of unused tax losses and other temporary differences to the extent that it is probable that there will be future taxable profits against which the losses and other temporary differences can be utilised. The Group has considered their carrying value as at 31 December 2017 and concluded that, based on management's estimates, sufficient taxable profits will be generated in future years to recover recognised deferred tax assets. These estimates are based on forecast performance and take into account Brexit, the Group's plans to implement the UK ring-fencing regime and the resultant transfers between members of the Group.

Deferred tax assets of £6,356 million (2016 - £7,940 million) have not been recognised in respect of tax losses and other temporary differences where the availability of future taxable profits is uncertain. Further details about the Group's deferred tax assets are given in Note 22 on the accounts.

(iv) 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 in accordance with Accounting policy 16. At 31 December 2017, customer loan impairment provisions amounted to £3,814 million (2016 - £4,455 million).

A loan is impaired when there is objective evidence that events since the loan was granted have affected expected cash flows from the loan. Such objective evidence, indicative that a borrower's financial condition has deteriorated, can include for loans that are individually assessed: the non-payment of interest or principal; debt renegotiation; probable bankruptcy or liquidation; significant reduction in the value of any security; breach of limits or covenants; and deteriorating trading performance and, for collectively assessed portfolios: the borrowers' payment status and observable data about relevant macroeconomic measures.

The impairment loss is the difference between the carrying value of the loan and the present value of estimated future cash flows at the loan's original effective interest rate.

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

Accounting policies

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

Collective component - this is made up of two elements: loan impairment provisions for impaired loans that are below individual assessment thresholds (collectively assessed provisions) and for loan losses that have been incurred but have not been separately identified at the balance sheet date (latent loss provisions). Collectively assessed provisions are established on a portfolio basis using a present value methodology taking into account the level of arrears, security, past loss experience, credit scores and defaults based on portfolio trends. The most significant factors in establishing these provisions are the expected loss rates and the related average life. These portfolios include mortgages, credit card receivables and other personal lending. The future credit quality of these portfolios is subject to uncertainties that could cause actual credit losses to differ materially from reported loan impairment provisions. These uncertainties include the economic environment, notably interest rates and their effect on customer spending, the unemployment level, payment behaviour and bankruptcy trends. Latent loss provisions are held against estimated impairment losses in the performing portfolio that have yet to be identified as at the balance sheet date. To assess the latent loss within its portfolios, the Group has developed methodologies to estimate the time that an asset can remain impaired within a performing portfolio before it is identified and reported as such.

(v) Fair value - financial instruments

In accordance with Accounting policies 14, 16 and 23, 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.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement takes into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date.

It also uses the assumptions that market participants would use when pricing the asset or liability. In determining fair value the Group maximises the use of relevant observable inputs and minimises the use of unobservable inputs.

Where the Group manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, it measures the fair value of a group of financial assets and financial liabilities on the basis of the price that it would receive to sell a net long position (i.e. an asset) for a particular risk exposure or to transfer a net short position (i.e. a liability) for a particular risk exposure in an orderly transaction at

the measurement date under current market conditions.

Credit valuation adjustments are made when valuing derivative financial assets to incorporate counterparty credit risk. Adjustments are also made when valuing financial liabilities measured at fair value to reflect the Group's own credit standing.

Where the market for a financial instrument is not active, fair value is established using a valuation technique. These valuation techniques involve a degree of estimation, the extent of which depends on the instrument's complexity and the availability of market-based data. Further details about the Group's valuation methodologies and the sensitivity to reasonably possible alternative assumptions of the fair value of financial instruments valued using techniques where at least one significant input is unobservable are given in Note 9 on the accounts.

Accounting developments

International Financial Reporting Standards

A number of IFRSs and amendments to IFRS were in issue at 31 December 2017 that would affect the Group from 1 January 2018 or later.

Effective 1 January 2018 - IFRS 9

In July 2014, the IASB published IFRS 9 Financial Instruments with an effective date of 1 January 2018. IFRS 9 replaces the current financial instruments standard IAS 39, setting out new accounting requirements in a number of areas.

The principle features of IFRS 9 are as follows:

Recognition and derecognition

The sections in IAS 39 setting out the criteria for the recognition and derecognition of financial instruments have been included unamended in IFRS 9.

Classification and measurement

Financial assets - There are three classifications for financial assets in IFRS 9.

- *Amortised cost* - Financial assets with terms that give rise to interest and principal cash flows only and which are held in a business model whose objective is to hold financial assets to collect their cash flow are measured at amortised cost.

Accounting policies

- *Fair value through other comprehensive income* - Financial assets with terms that give rise to interest and principal cash flows only and which are held in a business model whose objective is achieved by holding financial assets to collect their cash flow and selling them are measured at fair value through other comprehensive income.
- *Fair value through profit and loss* - Other financial assets are measured at fair value through profit and loss.

At initial recognition, any financial asset may be irrevocably designated as measured at fair value through profit or loss if such designation eliminates a measurement or recognition inconsistency.

The measurement basis of the majority of the Group's financial assets is unchanged on application of IFRS 9.

Financial liabilities Since early adopting in 2017 the IFRS 9 accounting for fair value attributable to own credit risk there are no further material changes on accounting for financial liabilities on adoption of IFRS 9.

Hedge accounting

IFRS 9's hedge accounting requirements are designed to align the accounting more closely to the risk management framework; permit a greater variety of hedging instruments; and remove or simplify some of the rule-based requirements in IAS 39. The elements of hedge accounting: fair value, cash flow and net investment hedges are retained. The Group accounting policy choice is continue with the IAS 39 hedge accounting framework.

Credit impairment

IFRS 9's credit impairment requirements apply to financial assets measured at amortised cost, to those measured at fair value through other comprehensive income, to lease receivables and to certain loan commitments and financial guarantee contracts. On initial recognition a loss allowance is established at an amount equal to 12-month expected credit losses (ECL) that is the portion of life-time expected losses resulting from default events that are possible within the next 12 months. Where a significant increase in credit risk since initial recognition is identified, the loss allowance increases so as to recognise all expected default events over the expected life of the asset. The Group expects that financial assets where there is objective evidence of impairment under IAS 39 will be credit impaired under IFRS 9, and carry loss allowances based on all expected default events.

The assessment of credit risk and the estimation of ECL are required to be unbiased and probability-weighted: determined by evaluating at the balance sheet date for each customer or loan portfolio a range of possible outcomes using reasonable and supportable information about past events, current conditions and forecasts of future events and economic conditions. The estimation of ECL also takes into account the time value of

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money. Recognition and measurement of credit impairments under IFRS 9 are more forward-looking than under IAS 39.

A Group-wide programme implemented the necessary changes in the modelling of credit loss parameters, and the underlying credit management and financial processes.

The result is an increase in overall credit impairment provisions when compared with the current basis of measurement under IAS 39.

Transition

The classification and measurement and impairment requirements will be applied retrospectively by adjusting the opening balance sheet at the date of initial application, with no requirement to restate comparative periods. Hedge accounting will be applied prospectively from that date.

In summary, on 1 January 2018, the impact on shareholders' equity was a £71 million post tax reduction in equity, comprising:

- Reclassification of financial instruments £561 million pre tax increase in equity
- Change in impairment methodology £616 million pre tax reduction.
- Net tax impact £16 million decrease.

There will be no restatement of accounts prior to 2018.

The Group has opted to early adopt the IFRS 9 amendment on negative compensation with effect from 1 January 2018; this is expected to be endorsed for use in the EU in early 2018.

Effective 1 January 2018 other standards

IFRS 15 Revenue from Contracts with Customers was issued in May 2014. It will replace IAS 11 Construction Contracts, IAS 18 Revenue and several Interpretations. Contracts are bundled or unbundled into distinct performance obligations with revenue recognised as the obligations are met. A restatement is not expected on initial application of this standard.

IFRS 2 Share-based payment was amended in June 2016 to clarify the accounting for net settlement of tax in respect of share-based payments and the calculation of the cost of modified awards and those with vesting conditions that are not market conditions. IFRIC Interpretation 22 Foreign Currency Transaction and Advance Consideration was issued in December 2016 clarifying the date of a foreign exchange transaction to be used on initial recognition of a related asset or other item.

IAS 40 Investment Property was amended in December 2016 to clarify that transfers into or out of the investment property classification may only occur on a change of use or the property ceasing to meet the definition of an investment property.

On adoption, none of these standards are expected to have a material effect on the Group's results.

Accounting policies

Effective after 2018

IFRS 16 Leases was issued in January 2016 to replace IAS 17 Leases. There are no substantial changes to the accounting for leases by lessors nor for finance leases; operating leases will be brought on balance sheet through the recognition of assets representing the contractual rights of use, and liabilities will be recognised for the contractual payments that exist. The effective date is 1 January 2019.

The Group is currently working on the implementation of the new requirements and currently anticipates that the property lease portfolio will have the most significant implementation impact as property represents 87% of the operating lease commitments per Note 31. A preliminary estimate (excluding the impacts of tax) of the opening balance sheet adjustment as a result of the property portfolio using a modified retrospective approach to transition would be to create a Right of Use asset of c£1.4bn, also impacting RWAs and an estimated decrease (excluding the impacts of tax) in retaining earnings of some c£0.3bn. As permitted by the standard, the Group intends to apply IFRS 16 on a retrospective basis but to take advantage of the option not to restate. The Group will continue to work on the implementation throughout 2018 and therefore this estimate of the impact is subject to change. Changes could arise from the addition of non property leases, further development of calibration of models and processes, methodology and approach refinement, and sensitivity analysis performed on key assumptions such as discount factors and lease term.

IFRS 17 Insurance contracts was issued in May 2017 to replace IFRS 4 and to establish a comprehensive standard for inceptors of insurance policies. The effective date is 1 January 2021.

IFRIC Interpretation 23 Uncertainty over income tax treatments was issued in June 2017 to clarify how to apply judgement in assessing the tax position of the reporting entity. The effective date is 1 January 2019.

In October 2017, the IASB amended IAS 28 Investments in associates and joint ventures to require long term, non-equity interests in these investments to be tested for impairment first in accordance with IFRS 9 and then in accordance with IAS 28. The effective date of the amendment is 1 January 2019.

In February 2018 the IASB amended IAS Employee Benefits to clarify the need to update assumptions whenever there is a plan amendment, curtailment or settlement during the reporting period. The effective date is 1 January 2019.

The Group is assessing the effect of adopting these standards on its financial statements.

Notes on the consolidated accounts

1 Net interest income

	2017 £m	2016 £m	2015 £m
Loans and advances to customers	10,409	10,706	11,268
Loans and advances to banks	277	246	340
Debt securities	348	306	317
Interest receivable (1)	11,034	11,258	11,925
Customer accounts: demand deposits	99	433	619
Customer accounts: savings deposits	445	432	446
Customer accounts: other time deposits	179	190	315
Balances with banks	175	97	45
Debt securities in issue	554	557	759
Subordinated liabilities	572	845	869
Internal funding of trading businesses	23	(4)	105
Interest payable (1)	2,047	2,550	3,158
Net interest income	8,987	8,708	8,767

2 Non-interest income

	2017 £m	2016 £m	2015 £m
Fees and commissions receivable			
Payment services	829	856	923
Credit and debit card fees	665	645	738
Lending (credit facilities)	1,060	1,044	1,076
Brokerage	148	154	262
Investment management	249	250	305
Trade finance	173	196	242
Other	214	195	196
	3,338	3,340	3,742
Fees and commissions payable			
Banking	(883)	(805)	(809)
Income from trading activities			
Foreign exchange	525	989	809
Interest rate	(50)	(480)	35
Credit	197	336	(80)
Changes in fair value of own debt and derivative liabilities attributable to own credit			
- debt securities in issue	(81)	87	252
- derivative liabilities	12	67	2
Equities and other	31	(25)	42
	634	974	1,060

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Loss on redemption of own debt	(7)	(126)	(263)
Other operating income			
Operating lease and other rental income	276	287	276
Changes in the fair value of own debt designated as at fair value through profit or loss attributable to own credit risk (2)			
- debt securities in issue		41	84
- subordinated liabilities		(15)	(29)
Other changes in the fair value of financial assets and liabilities designated as at fair value through profit or loss and related derivatives	99	(13)	375
Changes in the fair value of investment properties	(14)	(11)	2
Profit/(loss) on sale of securities	226	71	(4)
Profit on sale of property, plant and equipment	75	18	91
Profit/(loss) on sale of subsidiaries and associates	245	273	(102)
Loss on disposal or settlement of loans and receivables	(35)	(277)	(558)
Share of profits of associated entities	104	59	140
Other income (3)	88	66	151
Non-interest income	1,064	499	426

Notes:

(1) Negative interest on loans and advances is classed as interest payable and on customer deposits is classed as interest receivable.

(2) Measured as the change in fair value from movements in the year in the credit risk premium payable by RBS. Ahead of adopting IFRS9 Financial Instruments from 1 January 2018, RBS has adopted the provisions in respect of the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss from 1 January 2017.

(3) Includes income from activities other than banking.

Notes on the consolidated accounts

3 Operating expenses

	2017 £m	2016 £m	2015 £m
Salaries	2,765	3,097	3,177
Variable compensation	298	281	314
Temporary and contract costs	415	674	638
Social security costs	318	388	344
Share-based compensation	17	32	36
Pension costs			
- defined benefit schemes (see Note 4)	309	267	523
- loss/(gain) on curtailments or settlements (see Note 4)	66	1	(65)
- defined contribution schemes	92	89	74
Severance	255	229	511
Other	141	66	174
Staff costs	4,676	5,124	5,726
Premises and equipment	1,565	1,388	1,827
UK bank levy	215	190	230
Other administrative expenses (1)	3,108	8,555	6,058
Property, plant and equipment depreciation and write down (see Note 16)	586	574	950
Intangible assets amortisation (see Note 15)	222	204	230
Depreciation and amortisation	808	778	1,180
Write down of goodwill and other intangible assets (see Note 15)	29	159	1,332
Operating expenses	10,401	16,194	16,353

Restructuring and divestment costs

Included in operating expenses are the following restructuring and divestment costs:

	2017 £m	2016 £m	2015 £m
Staff costs	753	642	830
Premises, equipment, depreciation and amortisation	471	164	746
Other administrative expenses (2)	341	1,300	1,355
Total	1,565	2,106	2,931

Notes:

- (1) Includes litigation and conduct costs, net of amounts recovered. Further details are provided in Note 20.
- (2) Includes other administrative expenses, write down of goodwill and other intangible assets.

Notes on the consolidated accounts

3 Operating expenses continued

The average number of persons employed, rounded to the nearest hundred, in continuing operations during the year, excluding temporary staff, was 73,400 (2016 - 82,400; 2015 - 88,800); on the same basis there were no people employed in discontinued operations (2016 - nil; 2015 - 10,100). The average number of temporary employees during 2017 was 5,000 (2016 - 6,700; 2015 - 7,800). The number of persons employed in continuing operations at 31 December, excluding temporary staff, by reportable segment, was as follows:

	2017	2016*	2015*
UK Personal & Business Banking	21,900	25,100	29,900
Ulster Bank Rol	2,600	3,000	2,500
Personal & Business Banking	24,500	28,100	32,400
Commercial Banking	4,500	5,600	5,700
Private Banking	1,500	1,700	1,900
Commercial & Private Banking	6,000	7,300	7,600
RBS International	1,600	800	700
NatWest Markets	5,300	1,500	2,500
Central items & other	32,300	39,300	44,600
Total	69,700	77,000	87,800
UK	51,200	57,300	64,100
USA	500	700	1,100
Europe	4,200	5,200	6,200
Rest of the World	13,800	13,800	16,400
Total	69,700	77,000	87,800

There were no people employed in discontinued operations at 31 December 2017 (2016 - nil; 2015 - nil).

* Re-presented to reflect segment reorganisation.

Share-based payments

As described in the Remuneration report on page 103, the Group grants share-based awards to employees principally on the following bases:

Award plan	Eligible employees	Nature of award	Vesting conditions (1)	Settlement
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Sharesave	UK, Republic of Ireland, Channel Islands, Gibraltar and Isle of Man	Option to buy shares under employee savings plan	Continuing employment or leavers in certain circumstances	2018 to 2022
Deferred performance awards	All	Awards of ordinary shares	Continuing employment or leavers in certain circumstances	2018 to 2024
Long-term incentives (2)	Senior employees	Awards of conditional shares or share options	Continuing employment or leavers in certain circumstances and/or achievement of performance conditions	2018 to 2024

Notes:

- (1) All awards have vesting conditions and therefore some may not vest.
- (2) Long-term incentives include the Executive Share Option Plan, the Long-Term Incentive Plan and the Employee Share Plan.

Notes on the consolidated accounts

3 Operating expenses continued

The fair value of options granted in 2017 was determined using a pricing model that included: expected volatility of shares determined at the grant date based on historical volatility over a period of up to five years; expected option lives that equal the vesting period; no dividends on equity shares; and risk-free interest rates determined from UK gilts with terms matching the expected lives of the options.

The strike price of options and the fair value on granting awards of fully paid shares is the average market price over the five trading days (three trading days for Sharesave) preceding grant date.

Sharesave	2017		2016		2015	
	Average exercise price £	Shares under option (million)	Average exercise price £	Shares under option (million)	Average exercise price £	Shares under option (million)
At 1 January	2.46	56	2.87	56	2.85	51
Granted	2.27	21	1.68	17	2.91	12
Exercised	2.46	(3)	2.37		2.38	(2)
Cancelled	2.49	(14)	3.02	(17)	2.98	(5)
At 31 December	2.38	60	2.46	56	2.87	56

Options are exercisable within six months of vesting; 3.7 million options were exercisable at 31 December 2017 (2016 - 8.1 million; 2015 - 1.0 million). The weighted average share price at the date of exercise of options was £2.77 (2016 - £1.78; 2015 - £3.54). At 31 December 2017, exercise prices ranged from £1.68 to £4.34 (2016 - £1.68 to £4.34; 2015 - £2.33 to £18.93) and the remaining average contractual life was 2.9 years (2016 - 2.9 years; 2015 - 2.9 years). The fair value of options granted in 2017 was £21 million (2016 - £18 million; 2015 - £12 million).

Deferred performance awards	2017		2016		2015	
	Value at grant £m	Shares awarded (million)	Value at grant £m	Shares awarded (million)	Value at grant £m	Shares awarded (million)
At 1 January	296	102	276	80	272	85
Granted	152	63	170	75	186	50
Forfeited	(11)	(4)	(19)	(7)	(34)	(11)
Vested	(173)	(60)	(131)	(46)	(148)	(44)
At 31 December	264	101	296	102	276	80

The awards granted in 2017 vest in three equal tranches on their anniversaries.

Long-term incentives

	Value at grant	2017 Shares awarded (million)	Options over shares (million)	Value at grant £m	2016 Shares awarded (million)	Options over shares (million)	Value at grant £m	2015 Shares awarded (million)	Options over shares (million)
At 1 January	119	38	4	153	44	5	214	69	7
Granted	35	15		37	16		39	11	
Vested/exercised	(22)	(7)		(39)	(12)		(51)	(18)	(2)
Lapsed	(30)	(9)	(2)	(32)	(10)	(1)	(49)	(18)	
At 31 December	102	37	2	119	38	4	153	44	5

The market value of awards vested/exercised in 2017 was £22 million (2016 - £40 million; 2015 - £55 million). There are vested options of 2 million shares exercisable up to 2020 (2016 - 4 million; 2015 - 5 million).

Notes on the consolidated accounts

3 Operating expenses continued

Variable compensation awards

The following tables analyse the Group variable compensation awards for 2017.

	2017 £m	Group 2016 £m	Change %
Non-deferred cash awards (2)	51	56	(9)
Total non-deferred variable compensation	51	56	(9)
Deferred bond awards	134	138	(3)
Deferred share awards	157	149	5
Total deferred variable compensation	291	287	1
Total variable compensation (3)	342	343	
Variable compensation as a % of adjusted operating profit (4)	7%	9%	
Proportion of variable compensation that is deferred of which	85%	84%	
- deferred bond awards	46%	48%	
- deferred share awards	54%	52%	

	2017 £m	2016 £m	2015 £m
Reconciliation of variable compensation awards to income statement charge			
Variable compensation awarded	342	343	373
Less: deferral of charge for amounts awarded for current year	(133)	(103)	(97)
Income statement charge for amounts awarded in current year	209	240	276
Add: current year charge for amounts deferred from prior years	96	147	140
Less: forfeiture of amounts deferred from prior years	(7)	(106)	(102)
Income statement charge for amounts deferred from prior years	89	41	38
Income statement charge for variable compensation (3)	298	281	314

Actual

Expected

					2019
Year in which income statement charge is expected to be taken	2015	2016	2017	2018	and beyond
for deferred variable compensation	£m	£m	£m	£m	£m
Variable compensation deferred from 2015 and earlier	140	147	16	6	1
Variable compensation deferred from 2016			80	20	13
Less: forfeiture of amounts deferred from prior years	(102)	(106)	(7)		
Variable compensation for 2017 deferred				89	44
	38	41	89	115	58

Notes:

- (1) The tables above relate to continuing businesses only.
- (2) Cash awards are limited to £2,000 for all employees.
- (3) Excludes other performance related compensation.
- (4) Adjusted operating profit before variable compensation expense.

Notes on the consolidated accounts

4 Pensions

Defined contribution schemes

The Group sponsors a number of defined contribution pension schemes in different territories, which new employees are offered the opportunity to join.

Defined benefit schemes

The Group sponsors a number of pension schemes in the UK and overseas, including the Main section of The Royal Bank of Scotland Group Pension Fund (the Main scheme) which operates under UK trust law and is managed and administered on behalf of its members in accordance with the terms of the trust deed, the scheme rules and UK legislation.

Pension fund trustees are appointed to operate each fund and ensure benefits are paid in accordance with the scheme rules and national law. The trustees are the legal owner of a scheme's assets, and have a duty to act in the best interests of all scheme members.

The schemes generally provide a pension of one-sixtieth of final pensionable salary for each year of service prior to retirement up to a maximum of 40 years and are contributory for current members. These have been closed to new entrants some ten years ago, although current members continue to build up additional pension benefits, currently subject to 2% maximum annual salary inflation, while they remain employed by the Group.

The Main scheme corporate trustee is RBS Pension Trustee Limited (the Trustee), a wholly owned subsidiary of National Westminster Bank Plc, Principal Employer of the Main scheme. The Board of the Trustee comprises four member trustee directors selected from eligible active staff, deferred and pensioner members who apply and six appointed by the Group. Under UK legislation a defined benefit pension scheme is required to meet the statutory funding objective of having sufficient and appropriate assets to cover its liabilities (the pensions that have been promised to members).

Similar governance principles apply to the Group's other pension schemes.

Investment strategy

The assets of the Main scheme, which represent 90% of plan assets at 31 December 2017 (2016 - 89%), are invested in a diversified portfolio of quoted and private equity, government and corporate fixed-interest and index-linked bonds, and other assets including real estate and

infrastructure.

The Main scheme employs derivative instruments to achieve a desired asset class exposure and to reduce the scheme's interest rate, inflation and currency risk. This means that the net funding position is considerably less sensitive to changes in market conditions than the value of the assets or liabilities in isolation.

	Main scheme	
	2017	2016
Major classes of plan assets as a percentage of total plan assets	%	%
Quoted assets		
Quoted equities		
- Consumer industry	6.7	4.6
- Manufacturing industry	1.8	1.8
- Energy and utilities	3.6	2.7
- Financial institutions	7.8	8.3
- Technology and telecommunications	1.9	2.3
- Other	0.1	0.8
Private equity	4.0	3.4
Index-linked bonds	30.6	31.4
Government fixed interest bonds	9.2	5.9
Corporate fixed interest bonds	15.8	17.9
Unquoted assets		
Corporate and other bonds	1.0	1.8
Hedge funds		0.2
Real estate	5.2	5.2
Derivatives	8.1	10.2
Cash and other assets	4.2	3.4
Equity exposure of equity futures	(3.6)	(1.8)
Cash exposure of equity futures	3.6	1.9
	100.0	100.0

Notes on the consolidated accounts

4 Pensions *continued*

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

	Notional amounts £bn	2017 Fair value		Notional amounts £bn	2016 Fair value	
		Assets £m	Liabilities £m		Assets £m	Liabilities £m
Inflation rate swaps	11	310	555	12	299	549
Interest rate swaps	44	8,161	4,779	41	9,440	5,442
Currency forwards	12	160	34	15	191	136
Equity and bond call options	2	428		2	799	1
Equity and bond put options	3	3	1	2		2
Other	4	327	444	4	1,719	1,816

The investment strategy of other schemes is similar to that of the Main scheme, adjusted to take account of the nature of liabilities, risk appetite of the trustees, size of the scheme and any local regulatory constraints.

Swaps are used to manage interest rate and inflation risk of the liabilities, as well as being used to manage other risks within the Main scheme. They have been executed at prevailing market rates and within standard market bid/offer spreads with a number of counterparty banks, including The Royal Bank of Scotland plc.

At 31 December 2017, the gross notional value of the swaps was £57 billion (2016 - £56 billion) and had a net positive fair value of £3,045 million (2016 - £3,629 million).

Collateral is required on all swap transactions. The counterparty banks had delivered a net amount of £3,436 million of collateral at 31 December 2017 (2016 - £3,991 million).

The schemes do not invest directly in the Group but can have exposure to the Group within their investment programmes through indirect exposure to ordinary shares of the Group through index tracking investments, swaps contracts (before allowing for collateral posted against the mark value of the swaps) and cash deposits placed with National Westminster Bank Plc. The trustees of the respective schemes are responsible for ensuring that indirect investments in the Group do not exceed the 5% regulatory limit.

Amounts in the Financial statements

The Group recognises the net pension scheme surplus or deficit as a net asset or liability. In doing so, the funded status is adjusted to reflect any schemes with a surplus that the Group may not be able to access, as well as any minimum funding requirement to pay in additional contributions. This is most relevant to the Main scheme, where the current surplus is not recognised.

	All schemes	
	2017	2016
Amounts recognised on the balance sheet	£m	£m
Fund assets at fair value	49,746	49,229
Present value of fund liabilities	42,378	43,990
Funded status	7,368	5,239
Asset ceiling/minimum funding	7,105	5,326
	263	(87)
	2017	2016
Net pension asset/(liability) comprises	£m	£m
Net assets of schemes in surplus (included in Prepayments, accrued income and other assets, Note 17)	392	276
Net liabilities of schemes in deficit	(129)	(363)
	263	(87)

Notes on the consolidated accounts

4 Pensions *continued*

	Main scheme				All schemes			
	Fair value of plan assets	Present value of defined benefit obligation	Asset ceiling/minimum funding (1)	Net pension liability/(asset)	Fair value of plan assets	Present value of defined benefit obligation	Asset ceiling/minimum funding (1)	Net pension liability/(asset)
	£m	£m	£m	£m	£m	£m	£m	£m
Changes in value of net pension liability/(asset)								
At 1 January 2016	30,703	30,966	2,981	3,244	34,708	35,152	3,130	3,574
Currency translation and other adjustments					533	602		69
Income statement								
Net interest expense	1,310	1,184	116	(10)	1,454	1,327	122	(5)
Current service cost		199		199		264		264
Past service cost		28		28		8		8
Loss on curtailments or settlements						1		1
	1,310	1,411	116	217	1,454	1,600	122	268
Statement of comprehensive income								
Return on plan assets above recognised interest income	8,562			(8,562)	9,254			(9,254)
Experience gains and losses		(658)		(658)		(794)		(794)
Effect of changes in actuarial financial assumptions		8,803		8,803		9,565		9,565
Effect of changes in actuarial demographic assumptions		(402)		(402)		(542)		(542)
Asset ceiling/minimum funding adjustments	8,562	7,743	1,876	1,876	9,254	8,229	2,074	2,074
			1,876	1,057			2,074	1,049
Contributions by employer	4,518			(4,518)	4,786			(4,786)
Contributions by plan participants and other scheme members					12	12		
Liabilities extinguished upon settlement					(43)	(130)		(87)
Benefits paid	(1,269)	(1,269)			(1,475)	(1,475)		
At 1 January 2017	43,824	38,851	4,973		49,229	43,990	5,326	87
Currency translation and other adjustments					46	46	3	3
Income statement								
Net interest expense	1,155	1,021	134		1,285	1,140	142	(3)
Current service cost		226		226		292		292
Past service cost		19		19		20		20
Loss on curtailments or settlement						66		66
	1,155	1,266	134	245	1,285	1,518	142	375
Statement of comprehensive income								

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Return on plan assets above recognised interest income	1,580			(1,580)	1,728			(1,728)
Experience gains and losses		107		107		93		93
Effect of changes in actuarial financial assumptions		678		678		737		737
Effect of changes in actuarial demographic assumptions		(794)		(794)		(826)		(826)
Asset ceiling/minimum funding adjustments	1,580	(9)	1,608	1,608	19	1,728	4	1,634
								1,634
								(90)
Contributions by employer	264			(264)	627			(627)
Contributions by plan participants and other scheme members	4	4			10	10		
Liabilities extinguished upon settlement					(744)	(755)		(11)
Benefits paid	(2,175)	(2,175)			(2,435)	(2,435)		
At 31 December 2017	44,652	37,937	6,715		49,746	42,378	7,105	(263)

Notes:

(1) In recognising the net surplus or deficit of a pension scheme, the funded status of each scheme is adjusted to reflect any minimum funding requirement imposed on the sponsor and any ceiling on the amount that the sponsor has an unconditional right to recover from a scheme.

(2) The Group expects to make contributions to the Main scheme of £190 million in 2018.

Notes on the consolidated accounts

4 Pensions *continued*

Funding and contributions by the Group

In the UK, the Trustees of defined benefit pension schemes are required to perform funding valuations every three years. The Trustees and the Company, with the support of the Scheme Actuary, agree the assumptions used to value the liabilities and a Schedule of Contributions required to eliminate any funding deficit. The funding assumptions incorporate a margin for prudence over and above the expected cost of providing the benefits promised to members, taking into account the sponsor's covenant and the investment strategy of the scheme. Similar arrangements apply in the other territories where the Group sponsors defined benefit pension schemes. The last funding valuation of the Main scheme was at 31 December 2015 and next funding valuation is due at 31 December 2018, to be agreed by 31 March 2020.

The triennial funding valuation of the Main scheme as at 31 December 2015 determined the funding level to be 84%, pension liabilities to be £37 billion and the deficit to be £5.8 billion, subsequently reduced by a £4.2 billion cash payment in March 2016. Investment returns over the next 10 year period were forecast to absorb the £1.6 billion balance of the deficit. The average cost of the future service of current members is 35% of basic salary before contributions from those members; it includes the expenses of running the scheme.

Assumptions

Placing a value on the Group's defined benefit pension schemes' liabilities requires the Group's management to make a number of assumptions, with the support of independent actuaries who provide advice and guidance to the Group. The ultimate cost of the defined benefit obligations to the Group will depend upon actual future events and the assumptions made are unlikely to be exactly borne out in practice, meaning the final cost may be higher or lower than expected.

The most significant assumptions used for the Main scheme are shown below:

	Principal IAS 19 actuarial assumptions		Principal assumptions of 2015 triennial valuation 2015
	2017	2016	
Discount rate	% 2.6	% 2.7	Fixed interest swap yield curve plus 1.5% per annum at all durations
Inflation assumption (RPI)	3.1	3.2	Retail price index RPI swap yield curve
Rate of increase in salaries	1.8	1.8	
Rate of increase in deferred pensions	3.0	3.2	
Rate of increase in pensions in payment	2.9	3.0	(RPI floor 0%, cap 5%): Limited price indexation (LPI)

(0,5) swap yield curve

Proportion of pension converted to a cash lump sum at retirement

	21	21	21%
Longevity at age 60 for current pensioners (years)			
Males	27.2	27.4	28.4
Females	28.7	29.1	30.2
Longevity at age 60 for future pensioners currently aged 40 (years)			
Males	28.6	29.0	29.9
Females	30.4	31.2	32.4

Discount rate

The Group discounts its defined benefit pension obligations at discount rates determined by reference to the yield on high quality corporate bonds.

The sterling yield curve (applied to 96% of the Group's defined benefit obligations) is constructed by reference to yields on AA corporate bonds from which a single discount rate is derived based on a cash flow profile similar in structure and duration to the pension obligations. The weighted average duration of the Main scheme's defined benefit obligation at 31 December 2017 is 21 years (2016 20.9 years).

Significant judgement is required when setting the criteria for bonds to be included in the population from which the yield curve is derived.

The criteria include issue size, quality of pricing and the exclusion of outliers. Judgement is also required in determining the shape of the yield curve at long durations: a constant credit spread relative to gilts is assumed.

Notes on the consolidated accounts

4 Pensions continued

The table below shows how the present value of the defined benefit obligation would change if the key assumptions used were changed. The sensitivity analysis presented below may not be representative of the actual change in the defined benefit obligation as it is unlikely that the changes in assumptions would occur in isolation of one another as some of the assumptions may be correlated.

	Main scheme (decrease)/increase in obligation at 31 December	
	2017 £m	2016 £m
0.25% increase in the discount rate	(1,964)	(1,978)
0.25% increase in inflation	1,329	1,552
0.25% additional rate of increase in pensions in payment	1,328	1,339
Longevity increase of one year	1,478	1,522

The defined benefit obligation is attributable to the different classes of scheme members in the following proportions (Main scheme):

Membership category	2017 %	2016 %
Active members	16.2	18.1
Deferred members	47.3	45.9
Pensioners and dependants	36.5	36.0
	100.0	100.0

The experience history of Group schemes is shown below:

History of defined benefit schemes	Main Scheme					All schemes				
	2017 £m	2016 £m	2015 £m	2014 £m	2013 £m	2017 £m	2016 £m	2015 £m	2014 £m	2013 £m
Fair value of plan assets	44,652	43,824	30,703	30,077	24,272	49,746	49,229	34,708	34,359	28,488
Present value of plan obligations	37,937	38,851	30,966	31,776	26,958	42,378	43,990	35,152	36,643	31,484
Net surplus/(deficit)	6,715	4,973	(263)	(1,699)	(2,686)	7,368	5,239	(444)	(2,284)	(2,996)
Experience (losses)/gains on plan liabilities	(107)	658	233	3	102	(93)	794	258	18	176
Experience gains/(losses) on plan assets	1,580	8,562	(415)	4,629	986	1,728	9,254	(458)	5,171	1,097
Actual return on plan assets	2,735	9,872	703	5,766	1,997	3,013	10,708	749	6,485	2,270
Actual return on plan assets - %	6.2%	32.2%	2.3%	23.8%	8.9%	6.1%	30.9%	2.2%	22.8%	8.6%

Notes on the consolidated accounts

5 Auditor s remuneration

Amounts paid to the Group s auditors for statutory audit and other services are set out below. All audit-related and other services are approved by the Group Audit Committee and are subject to strict controls to ensure the external auditor s independence is unaffected by the provision of other services. The Group Audit Committee recognises that for certain assignments the auditors are best placed to perform the work economically; for other work the Group selects the supplier best placed to meet its requirements. The Group s auditors are permitted to tender for such work in competition with other firms where the work is permissible under audit independence rules.

On 24 March 2016 Deloitte LLP (Deloitte) resigned as the Group s auditors and at the Annual General Meeting on 4 May 2016 the shareholders approved the appointment of Ernst & Young LLP (EY) as the Group s auditor for the audit of the 2016 annual accounts. EY remain the Group s auditors for the audit of the 2017 annual accounts.

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

	2017	2016 (1)
	£m	£m
EY		
Fees payable for the audit of the Group s annual accounts	4.0	4.0
- the audit of the company s subsidiaries	22.9	20.7
- audit-related assurance services (2)	4.3	4.0
Total audit and audit-related assurance services fees	31.2	28.7
Other assurance services	1.7	3.4
Corporate finance services (3)	0.2	0.2
Total other services	1.9	3.6
	2017	2016 (4)
	£m	£m
Deloitte		
Fees payable to the auditor and its associates for other services to the Group		
- the audit of the company s subsidiaries		0.2
- audit-related assurance services (5)		0.5
Total audit and audit-related assurance services fees		0.7
Other assurance services		0.2
Corporate finance services (6)		1.3
Total other services		1.5
Total		2.2

Notes:

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- (1) Includes fees for the period EY were principal Group auditor (2016 - 1 January 2016 - 31 December 2016; Deloitte 2016 to effective resignation on 24 March 2016.)
- (2) Comprises fees of £1.1 million (2016 - £1.1 million) in relation to reviews of interim financial information, £2.5 million (2016 - £2.2 million) in respect of reports to the Group's regulators in the UK and overseas, £0.7 million (2016 - £0.7 million) in relation to non-statutory audit opinions.
- (3) Comprises fees of £0.2 million (2016 - £0.2 million) in respect of work performed by the auditors as reporting accountants on debt and equity issuances undertaken by the Group.
- (4) Includes fees for the period Deloitte were principal Group auditor (2016 1 January 2016 to effective resignation on 24 March 2016)
- (5) Comprises no fees (2016 - nil) in relation to revenues of interim financial information, no fees (2016 - £10 million) in respect of reports to the Group's regulators in the UK and overseas, no fees (2016 - £0.2 million) in respect of internal controls assurance, and no fees in relation to non-statutory audit opinions.
- (6) Comprises no fees (2016 £1.4 million) in respect of work performed by the auditors as reporting accountants as debt and equity issuances undertake by the Group, including securitisations, no fees (2016 - £0.1 million), and no fees (2016 - nil) in relation to working capital report in correction with a circular to shareholders.

Notes on the consolidated accounts

6 Tax

	2017 £m	2016 £m	2015 £m
Current tax:			
Charge for the year	(1,018)	(1,126)	(249)
Over provision in respect of prior years	227	186	220
	(791)	(940)	(29)
Deferred tax:			
Credit for the year	108	246	
Reduction in the carrying value of deferred tax assets	(30)	(317)	
(Under)/over provision in respect of prior years	(111)	(155)	6
Tax charge for the year	(824)	(1,166)	(23)

The actual tax charge differs from the expected tax charge computed by applying the standard rate of UK corporation tax of 19.25% (2016 20.00%; 2015 20.25%) as follows:

	2017 £m	2016 £m	2015 £m
Expected tax (charge)/credit	(431)	816	547
Losses and temporary differences in year where no deferred tax asset recognised	(303)	(742)	(1,086)
Foreign profits taxed at other rates	104	340	510
UK tax rate change impact (1)	(7)	6	94
Non-deductible goodwill impairment			(124)
Items not allowed for tax:			
- losses on disposals and write-downs	(69)	(45)	(23)
- UK bank levy	(45)	(41)	(50)
- regulatory and legal actions	(56)	(952)	(232)
- other disallowable items	(110)	(141)	(199)
Non-taxable items	134	136	173
Taxable foreign exchange movements	27	(57)	19
Losses brought forward and utilised	11	10	122
Reduction in carrying value of deferred tax asset in respect of:			
- UK losses	(30)	(317)	
Banking surcharge	(165)	(210)	
Adjustments in respect of prior years (2)	116	31	226
Actual tax charge	(824)	(1,166)	(23)

Notes:

(1) In recent years, the UK government has steadily reduced the rate of UK corporation tax, with the latest enacted rates standing at 20% with effect from 1 April 2015, 19% from 1 April 2017 and 17% from 1 April 2020. The Finance (No 2) Act 2015 restricts the rate at which tax losses are given credit in future periods to the main rate of UK corporation tax, excluding the Banking Surcharge 8% rate introduced by this Act. Deferred tax assets and liabilities at 31 December 2017 take into account the reduced rates in respect of tax losses and non-banking temporary differences and where appropriate, the banking surcharge inclusive rate in respect of other banking temporary differences.

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(2) Prior year tax adjustments incorporate refinements to tax computations made on submission and agreement with the tax authorities. Current taxation balances include provisions in respect of uncertain tax positions, in particular in relation to restructuring and other costs where the taxation treatment remains subject to agreement with the relevant tax authorities.

Notes on the consolidated accounts

7 Earnings per ordinary share

Earnings per ordinary share have been calculated based on the following:

	2017 £m	2016 £m	2015 £m
Earnings			
Profit/(loss) attributable to ordinary shareholders	752	(6,955)	(1,979)
Loss from discontinued operations attributable to ordinary shareholders			(1,207)
Profit/(loss) from continuing operations attributable to ordinary shareholders	752	(6,955)	(3,186)
Weighted average number of shares (millions) (1)			
Weighted average number of ordinary shares outstanding during the year	11,867	11,692	11,516
Effect of dilutive share options and convertible securities	69	51	60
Diluted weighted average number of ordinary shares outstanding during the year	11,936	11,743	11,576

Note:

- (1) All periods include the effect of 51 billion B shares that were converted to 5.1 billion ordinary shares in October 2015 (see Note 25).

There were no basic earnings/(loss) per ordinary share from discontinued operations (2016 - nil; 2015 10.5p). There were no diluted earnings per ordinary share from discontinued operations (2016 nil; 2015 10.4p).

An agreement on 25 June 2014 between RBS and Her Majesty's Treasury (HMT) set out the terms for the retirement of the Dividend Access Share (DAS).

On 22 March 2016 the DAS was retired on payment the final dividend of £1,193 million to HMT; the DAS was re-designated as a single B share which was then cancelled.

Earnings per share for periods ended after 25 June 2014 and prior to the retirement of the DAS reflect DAS dividends recognised before the end of a reporting period; this amounted to nil (2016 £1,193; 2015- nil).

8 Financial instruments - classification

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The following tables analyse financial assets and liabilities in accordance with the categories of financial instruments in IAS 39. Assets and liabilities outside the scope of IAS 39 are shown within other assets and other liabilities.

	Held-for- trading £m	Designated as at fair value through profit or loss £m	Hedging derivatives £m	Available- for-sale £m	Loans and receivables £m	Held-to- maturity £m	Other assets £m	Total £m
Assets								
Cash and balances at central banks					98,337			98,337
Loans and advances to banks								
- reverse repos	11,845				2,152			13,997
- other (1)	6,889				9,365			16,254
Loans and advances to customers								
- reverse repos	24,427				2,308			26,735
- other	15,320	56			307,808			323,184
Debt securities	27,481			43,681	3,643	4,128		78,933
Equity shares	29	134		287				450
Settlement balances					2,517			2,517
Derivatives	157,876		2,967					160,843
Other assets							16,806	16,806
31 December 2017	243,867	190	2,967	43,968	426,130	4,128	16,806	738,056
Cash and balances at central banks					74,250			74,250
Loans and advances to banks								
- reverse repos	11,120				1,740			12,860
- other (1)	6,780				10,498			17,278
Loans and advances to customers								
- reverse repos	26,586				2,341			28,927
- other	17,504	82			305,437			323,023
Debt securities	24,504	27		39,254	3,968	4,769		72,522
Equity shares	166	172		365				703
Settlement balances					5,526			5,526
Derivatives	242,192		4,789					246,981
Other assets							16,586	16,586
31 December 2016	328,852	281	4,789	39,619	403,760	4,769	16,586	798,656

Note:

(1) Includes items in the course of collection from other banks of £1,017 million (2016 - £781 million).

Notes on the consolidated accounts

8 Financial instruments - classification continued

	Held-for- trading £m	Designated as at fair value through profit or loss £m	Hedging derivatives £m	Amortised cost £m	Other liabilities £m	Total £m
Liabilities						
Deposits by banks						
- repos	4,030			3,389		7,419
- other (1)	12,472			27,007		39,479
Customer accounts						
- repos	24,333			6,669		31,002
- other (2)	11,513	874		354,647		367,034
Debt securities in issue (3)	1,107	3,403		26,049		30,559
Settlement balances				2,844		2,844
Short positions	28,527					28,527
Derivatives	150,935		3,571			154,506
Subordinated liabilities		939		11,783		12,722
Other liabilities				2,181	12,690	14,871
31 December 2017	232,917	5,216	3,571	434,569	12,690	688,963
Deposits by banks						
- repos	4,125			1,114		5,239
- other (1)	20,756			12,561		33,317
Customer accounts						
- repos	23,186			3,910		27,096
- other (2)	12,778	1,506		339,588		353,872
Debt securities in issue (3)	1,614	4,621		21,010		27,245
Settlement balances				3,645		3,645
Short positions	22,077					22,077
Derivatives	232,418		4,057			236,475
Subordinated liabilities		955		18,464		19,419
Other liabilities				2,010	18,857	20,867
31 December 2016	316,954	7,082	4,057	402,302	18,857	749,252

Notes:

(1) Includes items in the course of transmission to other banks of £214 million (2016 - £295 million).

(2) The carrying amount of other customer accounts designated as at fair value through profit or loss is £114 million (2016 - £155 million) higher than the principal amount. No amounts have been recognised in profit or loss for changes in credit risk associated with these liabilities as the changes are immaterial both during the period and cumulatively. Measured as the change in fair value from movements in the period in the credit

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risk premium payable.

(3) Comprises bonds and medium term notes of £25,922 million (2016 - £24,037 million) and certificates of deposit and other commercial paper of £4,637 million (2016 - £3,208 million).

Amounts included in operating profit/(loss) before tax:

	2017	2016	2015
	£m	£m	£m
Gains on financial assets/liabilities designated as at fair value through profit or loss	60	13	388
Losses on disposal or settlement of loans and receivables	(35)	(277)	(558)

Notes on the consolidated accounts

8 Financial instruments - classification continued

The tables below present information on financial assets and financial liabilities that are offset on the balance sheet under IFRS or subject to enforceable master netting agreement together with financial collateral received or given.

	Offsetable instruments			Offsetable potential not recognised by IFRS			Net amount after the effect of netting arrangements and related collateral	Instruments outside netting	
	Gross	offset	sheet	Effect of master netting and similar agreements	Cash collateral	Other collateral		arrangements	sheet total
	£m	£m	£m	£m	£m	£m	£m	£m	£m
2017									
Assets									
Derivatives	175,670	(17,088)	158,582	(128,287)	(20,311)	(5,850)	4,134	2,261	160,843
Reverse repos	78,991	(43,974)	35,017	(329)		(34,646)	42	5,715	40,732
Loans to customers	1,110	(1,110)						323,184	323,184
Settlement balances	685	(668)	17				17	2,500	2,517
	256,456	(62,840)	193,616	(128,616)	(20,311)	(40,496)	4,193	333,660	527,276
Liabilities									
Derivatives	170,405	(17,557)	152,848	(128,287)	(18,035)	(3,952)	2,574	1,658	154,506
Repos	80,088	(43,974)	36,114	(329)		(35,785)		2,307	38,421
Customer accounts	641	(641)						367,034	367,034
Settlement balances	1,620	(668)	952				952	1,892	2,844
	252,754	(62,840)	189,914	(128,616)	(18,035)	(39,737)	3,526	372,891	562,805
2016									
Assets									
Derivatives	293,728	(51,080)	242,648	(197,288)	(28,742)	(8,435)	8,183	4,333	246,981
Reverse repos	69,805	(31,728)	38,077	(1,052)		(36,938)	87	3,710	41,787
Loans to customers	600	(600)						323,023	323,023
Settlement balances	1,711	(1,529)	182				182	5,344	5,526
	365,844	(84,937)	280,907	(198,340)	(28,742)	(45,373)	8,452	336,410	617,317
Liabilities									
Derivatives	284,255	(50,574)	233,681	(197,288)	(20,417)	(11,048)	4,928	2,794	236,475
Repos	61,742	(31,728)	30,014	(1,052)		(28,960)	2	2,321	32,335
Customer accounts	1,106	(1,106)						353,872	353,872
Settlement balances	1,677	(1,529)	148				148	3,497	3,645
	348,780	(84,937)	263,843	(198,340)	(20,417)	(40,008)	5,078	362,484	626,327

Loans and deposits on the balance sheet include cash collateral given or taken against the derivative portfolio. Where offset is available but not recognised under IFRS, this is reflected in the cash collateral column.

Notes on the consolidated accounts

9 Financial instruments - valuation

Valuation of financial instruments carried at fair value

Control environment

RBS's control environment for the determination of the fair value of financial instruments includes formalised protocols for the review and validation of fair values independent of the businesses entering into the transactions. There are specific controls to ensure consistent pricing policies and procedures, incorporating disciplined price verification. RBS ensures that appropriate attention is given to bespoke transactions, structured products, illiquid products and other instruments which are difficult to price.

Independent price verification (IPV)

IPV is a key element of the control environment. Valuations are first performed by the business which entered into the transaction. Such valuations may be directly from available prices, or may be derived using a model and variable model inputs. These valuations are reviewed, and if necessary amended, by a team independent of those trading the financial instruments, in the light of available pricing evidence.

IPV differences are classified according to the quality of independent market observables into IPV quality bands linked to the fair value hierarchy principles, as laid out in IFRS 13 'Fair Value Measurement'. These differences are classified into fair value levels 1, 2 and 3 (with the valuation uncertainty risk increasing as the levels rise from 1 to 3) and then further classified into high, medium, low and indicative depending on the quality of the independent data available to validate the prices. Valuations are revised if they are outside agreed thresholds.

Governance framework

IPV takes place at least each month end date, for all fair value positions. The IPV control includes formalised reporting and escalation of any valuation differences in breach of established thresholds. The Pricing Unit determines IPV policy, monitors adherence to that policy and performs additional independent reviews of highly subjective valuation issues.

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The Modelled Product Review Committee sets the policy for model documentation, testing and review, and prioritises models with significant exposure being reviewed by the RBS Pricing Model Risk team. The NatWest Markets Valuation Committee is made up of valuation specialists and senior business representatives from various functions and oversee pricing, reserving and valuations issues. This committee meets monthly to review and ratify any methodology changes. The Executive Valuation Committee meets quarterly to address key material and subjective valuation issues, to review items escalated by the NatWest Markets Valuation Committee and to discuss other relevant matters including prudential valuation.

Valuation hierarchy

Initial classification of a financial instrument is carried out by the Product Control team following the principles in IFRS 13. They base their judgment on information gathered during the IPV process for instruments which include the sourcing of independent prices and model inputs. The quality and completeness of the information gathered in the IPV process gives an indication as to the liquidity and valuation uncertainty of an instrument.

These initial classifications are reviewed and challenged by the Pricing Unit and are also subject to senior management review. Particular attention is paid to instruments crossing from one level to another, new instrument classes or products, instruments that are generating significant profit and loss and instruments where valuation uncertainty is high.

Valuation techniques

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

Non-modelled products

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

Modelled products

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

Inputs to valuation models

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

- Bond prices - quoted prices are generally available for government bonds, certain corporate securities and some mortgage-related products.

- Credit spreads - where available, these are derived from prices of credit default swaps or other credit based instruments, such as debt securities. For others, credit spreads are obtained from pricing services. For counterparty credit spreads, adjustments are made to market prices (or parameters) when the creditworthiness of the counterparty differs from that of the assumed counterparty in the market price (or parameters).

Notes on the consolidated accounts

9 Financial instruments - valuation *continued*

- Interest rates - these are principally benchmark interest rates such as the London Interbank Offered Rate (LIBOR), Overnight Index Swaps (OIS) rate and other quoted interest rates in the swap, bond and futures markets.
- Foreign currency exchange rates - there are observable prices both for spot and forward contracts and futures in the world's major currencies.
- Equity and equity index prices - quoted prices are generally readily available for equity shares listed on the world's major stock exchanges and for major indices on such shares.
- Commodity prices - many commodities are actively traded in spot and forward contracts and futures on exchanges in London, New York and other commercial centres.
- Price volatilities and correlations - volatility is a measure of the tendency of a price to change with time. Correlation measures the degree which two or more prices or other variables are observed to move together.
- Prepayment rates - the fair value of a financial instrument that can be prepaid by the issuer or borrower differs from that of an instrument that cannot be prepaid. In valuing prepayable instruments that are not quoted in active markets, RBS considers the value of the prepayment option.
- Recovery rates/loss given default - these are used as an input to valuation models and reserves for asset-backed securities and other credit products as an indicator of severity of losses on default. Recovery rates are primarily sourced from market data providers or inferred from observable credit spreads.

Consensus pricing

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RBS uses consensus prices for the IPV of some instruments. The consensus service encompasses the equity, interest rate, currency, commodity, credit, property, fund and bond markets, providing comprehensive matrices of vanilla prices and a wide selection of exotic products. NatWest Markets contributes to consensus pricing services where there is a significant interest either from a positional point of view or to test models for future business use. Data sourced from consensus pricing services are used for a combination of control processes including direct price testing, evidence of observability and model testing. In practice this means that RBS submits prices for all material positions for which a service is available. Data from consensus services are subject to the same level of quality review as other inputs used for IPV process.

In order to determine a reliable fair value, where appropriate, management applies valuation adjustments to the pricing information gathered from the above sources. The sources of independent data are reviewed for quality and are applied in the IPV processes using a formalised input quality hierarchy. These adjustments reflect RBS's assessment of factors that market participants would consider in setting a price.

Furthermore, on an ongoing basis, RBS assesses the appropriateness of any model used. To the extent that the price determined by internal models does not represent the fair value of the instrument, for instance in highly stressed market conditions, RBS makes adjustments to the model valuation to calibrate to other available pricing sources.

Where unobservable inputs are used, RBS may determine a range of possible valuations derived from differing stress scenarios to determine the sensitivity associated with the valuation. When establishing the fair value of a financial instrument using a valuation technique, RBS considers adjustments to the modelled price which market participants would make when pricing that instrument. Such adjustments include the credit quality of the counterparty and adjustments to compensate for model limitations.

Valuation reserves

When valuing financial instruments in the trading book, adjustments are made to mid-market valuations to cover bid-offer spread, liquidity and credit risk. A breakdown of valuation adjustments is provided in Capital and risk management: Balance sheet analysis - derivatives on page 206.

Credit valuation adjustments (CVA)

CVA represent an estimate of the adjustment to fair value that a market participant would make to incorporate the counterparty credit risk inherent in derivative exposures. CVA is actively managed by a credit and market risk hedging process, and therefore movements in CVA are partially offset by trading revenue on the hedges.

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

Where a positive exposure exists to a counterparty that is considered to be close to default, the CVA is calculated by applying expected losses to the current level of exposure. Otherwise, expected losses are applied to estimated potential future positive exposures which are modelled to reflect the volatility of the market factors which drive the exposures and the correlation between those factors.

Expected losses are determined from market implied probabilities of default and internally assessed recovery levels. The probability of default is calculated with reference to observable credit spreads and observable recovery levels. For counterparties where observable data do not exist, the probability of default is determined from the credit spreads and recovery levels of similarly rated entities.

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

Bid-offer, liquidity and other reserves

Fair value positions are adjusted to bid (long positions) or offer (short positions) levels, by marking individual cash positions directly to bid or offer or by taking bid-offer reserves calculated on a portfolio basis for derivatives exposures. The bid-offer approach is based on current market spreads and standard market bucketing of risk.

Notes on the consolidated accounts

9 Financial instruments - valuation [continued](#)

Bid-offer adjustments for each risk factor (including delta (the degree to which the price of an instrument changes in response to a change in the price of the underlying), vega (the degree to which the price of an instrument changes in response to the volatility in the price of the underlying), correlation (the degree to which prices of different instruments move together) are determined by aggregating similar risk exposures arising on different products. Additional basis bid-offer reserves are taken where these are charged in the market.

Bid-offer spreads vary by maturity and risk type to reflect different spreads in the market. For positions where there is no observable quote, the bid-offer spreads are widened in comparison to proxies to reflect reduced liquidity or observability. Bid-offer methodologies may also incorporate liquidity triggers whereby wider spreads are applied to risks above pre-defined thresholds.

As permitted by IFRS 13, netting is applied on a portfolio basis to reflect the value at which RBS believes it could exit the portfolio, rather than the sum of exit costs for each of the portfolio's individual trades. This is applied where the asset and liability positions are managed as a portfolio for risk and reporting purposes.

Vanilla risk on exotic products is typically reserved as part of the overall portfolio based calculation e.g. delta and vega risk on exotic products are included within the delta and vega bid-offer calculations.

Product related risks such as correlation risk, attract specific bid-offer reserves. Additional reserves are provided for exotic products to ensure overall reserves match market close-out costs. These market close-out costs inherently incorporate risk decay and cross-effects (taking into account how changes in one risk factor may affect other inputs rather than treating all risk factors independently) that are unlikely to be adequately reflected in a static hedge based on vanilla instruments. Where there is limited bid-offer information for a product, the pricing approach and risk management strategy are taken into account when assessing the reserve.

Reserves are also held in relation to fair value funding costs that are not within the scope of FVA, potential losses arising from receivables where there is a counterparty dispute and certain uncollateralised derivatives after the pricing impact of a significant novation in 2017 was incorporated into transactions of a similar nature.

The discount rates applied to derivative cash flows in determining fair value reflect any underlying collateral agreements. Collateralised derivatives are generally discounted at the relevant OIS-related rates at an individual trade level. Reserves are held to the extent that the discount rates applied do not reflect all of the terms of the collateral agreements.

Funding valuation adjustment (FVA)

FVA represents an estimate of the adjustment to fair value that a market participant would make to incorporate funding costs and benefits that arise in relation to uncollateralised derivative exposures.

Funding levels are applied to estimated potential future exposures, the modelling of which is consistent with the approach used in the calculation of CVA. The counterparty contingent nature of the exposures is reflected in the calculation.

Amounts deferred on initial recognition

On initial recognition of financial assets and liabilities valued using valuation techniques incorporating information other than observable market data, any difference between the transaction price and that derived from the valuation technique is deferred. Such amounts are recognised in profit or loss over the life of the transaction; when market data becomes observable; or when the transaction matures or is closed out as appropriate. At 31 December 2017, net gains of £56 million (2016 - £72 million) were carried forward. During the year, net gains of £64 million (2016 - £27 million) were deferred and £80 million (2016 - £48 million) were recognised in the income statement.

Own credit

RBS takes into account the effect of its own credit standing when valuing financial liabilities recorded at fair value in accordance with IFRS. Own credit spread adjustments are made when valuing issued debt held at fair value, including issued structured notes, and derivatives. An own credit adjustment is applied to positions where it is believed that counterparties would consider RBS's creditworthiness when pricing trades.

For issued debt this adjustment is based on debt issuance spreads above average inter-bank rates (at a range of tenors). Secondary senior debt issuance spreads are used in the calculation of the own credit adjustment applied to senior debt.

The fair value of RBS's derivative financial liabilities is also adjusted to reflect RBS's own credit risk through debit valuation adjustments (DVA). Expected gains are applied to estimated potential future negative exposures, the modelling of which is consistent with the approach used in the calculation of CVA. Expected gains are determined from market implied probabilities of default and recovery levels. FVA is considered the primary adjustment applied to derivative liabilities. The extent to which DVA and FVA overlap is eliminated from DVA.

The own credit adjustment does not alter cash flows, is not used for performance management, is disregarded for regulatory capital reporting processes and will reverse over time provided the liability is not repaid at a premium or a discount.

Notes on the consolidated accounts

9 Financial instruments - valuation *continued*

The own credit adjustments (OCA) recorded on held-for-trading (HFT) and designated as at fair value through profit or loss (DFV) debt securities in issue, subordinated liabilities and derivative liabilities are set out below. The cumulative adjustments below represent reductions/(increases) to the balance sheet liability amounts.

	Debt Securities in issue (3)		Subordinated liabilities DFV	Derivatives	Total
	HFT	DFV			
<i>Cumulative own credit adjustment (2)</i>	£m	£m	£m	£m	£m
2017	(47)	(37)	116		32
2016	(34)	(6)	196	81	237
<i>Carrying values of underlying liabilities</i>	£bn	£bn	£bn		
2017	1.1	3.4	0.9		
2016	1.6	4.6	1.0		

Notes:

- (1) The OCA does not alter cash flows and is not used for performance management.
- (2) Includes wholesale and retail note issuances.
- (3) The reserve movement between periods will not equate to the reported profit or loss or other comprehensive income related to own credit. RBS has early adopted the provisions within IFRS 9 Financial Instruments in respect of the presentation of gains and losses on financial liabilities designated at fair value through profit and loss from 1 January 2017. The balance sheet reserve is stated by converting underlying currency balances at spot rates for each period, whereas the income statement includes intra-period foreign exchange sell-offs.
- (4) The cumulative adjustment for debt securities in issue is opposite to that for subordinated liabilities: debt securities in issue were issued relatively recently at wider than current spreads, whilst many of the subordinated liabilities were issued before the financial crisis at significantly tighter spreads.

Key points

- The cumulative OCA decrease during the year was mainly due to the tightening of RBS issuance spreads. The OCA on senior debt is determined by reference to secondary debt issuance spreads, which tightened by 52 basis points at the five year level to 10 basis points at 31 December 2017 (31 December 2016 62 basis points).

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- RBS subordinated debt spreads at the five year level tightened to 169 basis points at 31 December 2017 (31 December 2016 281 basis points).
- RBS five year CDS credit spreads tightened to 75 basis points at 31 December 2017 (31 December 2016 125 basis points).
- DVA in respect of derivative liabilities has reduced to nil following the tightening in spreads in 2017, such that adjustments overlap with FVA and are thus eliminated from DVA.

Financial instruments: carried at fair value - valuation hierarchy

The following tables show financial instruments carried at fair value on the Group's balance sheet by valuation hierarchy level 1, level 2 and level 3 and related level 3 sensitivities.

	Level 1	Level 2	Level 3	Total	Level 3 sensitivity (5)	
	£bn	£bn	£bn	£bn	Favourable (£m)	Unfavourable (£m)
2017						
Assets						
Loans and advances		58.3	0.2	58.5		
Debt securities	56.8	13.2	1.2	71.2	30	(10)
- of which AFS	37.2	6.2	0.3	43.7		
Equity shares		0.3	0.2	0.5	20	(30)
- of which AFS		0.1	0.2	0.3	20	(20)
Derivatives		159.1	1.7	160.8	160	(170)
	56.8	230.9	3.3	291.0	210	(210)
Proportion	19.6%	79.3%	1.1%	100%		
Liabilities						
Customer accounts		53.0	0.2	53.2	20	(20)
Debt securities in issue		4.2	0.3	4.5	10	(10)
Short positions	23.7	4.8		28.5		
Derivatives		152.9	1.7	154.6	140	(140)
Subordinated liabilities		0.9		0.9		
	23.7	215.8	2.2	241.7	170	(170)
Proportion	9.8%	89.3%	0.9%	100%		

For the notes to this table refer to the following page.

Notes on the consolidated accounts

9 Financial instruments: carried at fair value - valuation hierarchy *continued*

	Level 1	Level 2	Level 3	Total	Level 3 sensitivity (5)	
	£bn	£bn	£bn	£bn	Favourable (£m)	Unfavourable (£m)
2016						
Assets						
Loans and advances		61.5	0.6	62.1	50	(50)
Debt securities (3)	53.8	9.2	0.8	63.8	70	(20)
- of which AFS	35.1	4.0	0.1	39.2	20	(10)
Equity shares	0.1	0.2	0.4	0.7	40	(50)
- of which AFS		0.1	0.3	0.4	30	(40)
Derivatives		244.2	2.7	246.9	200	(200)
	53.9	315.1	4.5	373.5	360	(320)
Proportion	14.4%	84.4%	1.2%	100%		
Liabilities						
Customer accounts		62.0	0.4	62.4	10	(20)
Debt securities in issue		5.6	0.6	6.2	40	(40)
Short positions	19.7	2.4		22.1		
Derivatives		234.4	2.0	236.4	120	(120)
Subordinated liabilities		1.0		1.0		
	19.7	305.4	3.0	328.1	170	(180)
Proportion	6.0%	93.1%	0.9%	100%		

Notes:

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

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

(a) quoted prices for similar instruments or identical instruments in markets which are not considered to be active; or

(b) valuation techniques where all the inputs that have a significant effect on the valuations are directly or indirectly based on observable market data.

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Level 2 instruments include non-G10 government securities, most government agency securities, investment-grade corporate bonds, certain mortgage products, including CLOs, most bank loans, repos and reverse repos, less liquid listed equities, state and municipal obligations, most notes issued, and certain money market securities and loan commitments and most OTC derivatives.

Level 3: instruments valued using a valuation technique where at least one input which could have a significant effect on the instrument's valuation, is not based on observable market data. Level 3 instruments primarily include cash instruments which trade infrequently, certain syndicated and commercial mortgage loans, certain emerging markets instruments, unlisted equity shares, certain residual interests in securitisations, asset-backed products and less liquid debt securities, certain structured debt securities in issue, and OTC derivatives where valuation depends upon unobservable inputs such as certain credit and exotic derivatives. No gain or loss is recognised on the initial recognition of a financial instrument valued using a technique incorporating significant unobservable data.

(2) Transfers between levels are deemed to have occurred at the beginning of the quarter in which the instruments were transferred. There were no significant transfers between level 1 and level 2.

(3) For an analysis of debt securities (by issuer, measurement classification and analysis of asset backed securities) and derivatives (by type of contract) refer to Capital and risk management - Credit risk.

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

(5) Sensitivity represents the favourable and unfavourable effect on the income statement or the statement of comprehensive income due to reasonably possible changes to valuations using reasonably possible alternative inputs in RBS's valuation techniques or models. Level 3 sensitivities are calculated on a trade or low level portfolio basis and hence these aggregated figures do not reflect the correlation between some of the sensitivities. In particular, for some portfolios, the sensitivities may be negatively correlated where a downward movement in one asset would produce an upward movement in another, but due to the additive presentation above, this correlation cannot be shown.

Notes on the consolidated accounts

9 Financial instruments: valuation techniques

The table below shows a breakdown of valuation techniques and the ranges for those unobservable inputs used in valuation models and techniques that have a material impact on the valuation of level 3 financial instruments.

	Level 3 (£bn)		Valuation technique	Unobservable inputs	Range	
	Assets	Liabilities			Low	High
Financial instruments						
Loans and advances	0.2		Price-based	Price	0%	100.53%
Debt securities	1.2		Price-based	Price	0	369.81 GBP
			Price-based	Price	99.94%	101.84%
Equity shares	0.2		Price-based	Price	0.164	585,066 GBP
			Valuation	Discount factor	9%	13%
			Valuation	Fund NAV	80%	120%
Customer accounts		0.2	DCF based on recoveries	Correlation	(29%)	86.05%
				Interest rate delta	(0.38%)	2.61%
Debt securities in issue		0.3	Price-based	Price	56.77 JPY	148.68 EUR
			Valuation	Fund NAV	0.202	977.24 GBP
Derivatives	1.7	1.7	DCF based on recoveries	Credit spreads	0.1 bps	500 bps
Credit	0.2	0.1	Option pricing model	Correlation	(50%)	80%
				Volatility	38%	80%
				Upfront points	0%	99%
				Recovery rate	10%	40%
Interest and foreign exchange contracts	1.4	1.5	Option pricing model	Correlation	(75%)	100%
				Volatility	0%	292%
Equity	0.1	0.1	Option pricing model	Correlation	(57%)	95%
				Forward	146%	189%
				Volatility	7%	11%

Notes:

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- (1) The table above excludes unobservable inputs where the impact on valuation is not significant. Movements in the underlying input may have a favourable or unfavourable impact on the valuation depending on the particular terms of the contract and the exposure. For example, an increase in the credit spread of a bond would be favourable for the issuer but unfavourable for the note holder. Whilst RBS indicates where it considers that there are significant relationships between the inputs, there inter-relationships will be affected by macro economic factors including interest rates, foreign exchange rates or equity index levels.
- (2) Credit spreads and discount margins: credit spreads and margins express the return required over a benchmark rate or index to compensate for the credit risk associated with a cash instrument. A higher credit spread would indicate that the underlying instrument has more credit risk associated with it. Consequently, investors require a higher yield to compensate for the higher risk. The discount rate comprises credit spread or margin plus the benchmark rate; it is used to value future cash flows.
- (3) Price and yield: There may be a range of prices used to value an instrument that may be a direct comparison of one instrument or portfolio with another or, movements in a more liquid instrument may be used to indicate the movement in the value of a less liquid instrument. The comparison may also be indirect in that adjustments are made to the price to reflect differences between the pricing source and the instrument being valued, for example different maturity, credit quality, seniority or expected pay-outs. Similarly to price, an instrument's yield may be compared with other instruments' yields either directly or indirectly.
- (4) Recovery rate: reflects market expectations about the return of principal for a debt instrument or other obligations after a credit event or on liquidation. Recovery rates tend to move conversely to credit spreads.
- (5) Valuation: for private equity investments, risk may be measured by beta, estimated by looking at past prices of similar stocks and from valuation statements where valuations are usually derived from earnings measures such as EBITDA or net asset value.
- (6) Correlation: measures the degree by which two prices or other variables are observed to move together. If they move in the same direction there is positive correlation; if they move in opposite directions there is negative correlation. Correlations typically include relationships between: default probabilities of assets in a basket (a group of separate assets), exchange rates, interest rates and other financial variables.
- (7) Volatility: a measure of the tendency of a price to change with time.
- (8) Interest rate delta: these ranges represent the low/high marks on the relevant discounting curve.
- (9) Upfront points: where CDS contracts are standardised, the inherent spread of the trade may exceed the standard premium paid or received under the contract. Upfront points will compensate for the difference between the standard premium and the actual premium at the start of the contract.
- (10) RBS does not have any material liabilities measured at fair value that are issued with an inseparable third party credit enhancement.

Notes on the consolidated accounts

9 Financial instruments - valuation *continued*

The Level 3 sensitivities on the previous page are calculated at a trade or low level portfolio basis. They are not calculated on an overall portfolio basis and therefore do not reflect the likely potential uncertainty on the portfolio as a whole. The figures are aggregated and do not reflect the correlated nature of some of the sensitivities. In particular, for some of the portfolios the sensitivities may be negatively correlated where a downwards movement in one asset would produce an upwards movement in another, but due to the additive presentation of the above figures this correlation cannot be displayed. The actual potential downside sensitivity of the total portfolio may be less than the non-correlated sum of the additive figures as shown in the above table.

Areas of judgment

Whilst the business has simplified, the diverse range of products historically traded by RBS results in a wide range of instruments that are classified into Level 3 of the hierarchy. Whilst the majority of these instruments naturally fall into a particular level, for some products an element of judgment is required. The majority of RBS financial instruments carried at fair value are classified as Level 2: inputs are observable either directly (i.e. as a price) or indirectly (i.e. derived from prices).

Active and inactive markets

A key input in the decision making process for the allocation of assets to a particular level is market activity. In general, the degree of valuation uncertainty depends on the degree of liquidity of an input.

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

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

The breadth and depth of the IPV data allows for a rules based quality assessment to be made of market activity, liquidity and pricing uncertainty, which assists with the process of allocation to an appropriate level. Where suitable independent pricing information is not readily available, the quality assessment will result in the instrument being assessed as Level 3.

Modelled products

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

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

If an input fails the observability or quality tests then the instrument is considered to be in Level 3 unless the input can be shown to have an insignificant effect on the overall valuation of the product.

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

Non-modelled products

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

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

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

Notes on the consolidated accounts

9 Financial instruments: level 3 portfolios and sensitively methodologies

Reasonably plausible alternative assumptions of unobservable inputs are determined based on a specified target level of certainty of 90%. The assessments recognise different favourable and unfavourable valuation movements where appropriate. Each unobservable input within a product is considered separately and sensitivity is reported on an additive basis.

Alternative assumptions are determined with reference to all available evidence including consideration of the following: quality of independent pricing information taking into account consistency between different sources, variation over time, perceived tradability or otherwise of available quotes; consensus service dispersion ranges; volume of trading activity and market bias (e.g. one-way inventory); day 1 profit or loss arising on new trades; number and nature of market participants; market conditions; modelling consistency in the market; size and nature of risk; length of holding of position; and market intelligence.

Other considerations

Whilst certain inputs used to calculate CVA, FVA and own credit adjustments are not based on observable market data, the uncertainty of the inputs is not considered to have a significant effect on the net valuation of the related derivative portfolios and issued debt. The classification of the derivative portfolios and issued debt is not determined by the observability of these inputs and any related sensitivity does not form part of the Level 3 sensitivities presented.

Level 3

The following table shows the movement in level 3 assets and liabilities in the year.

	2017			Total liabilities	2016			Total liabilities
	FVTPL assets (2) £m	AFS assets £m	Total assets £m		FVTPL assets (2) £m	AFS assets £m	Total assets £m	
At 1 January	4,111	426	4,537	2,997	3,152	765	3,917	2,716
Amount recorded in the income statement								
(1) Amount recorded in the statement of comprehensive	(654)	82	(572)	(341)	(124)	5	(119)	(70)

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income		2	2			71	71	
Level 3 transfers in	719	275	994	530	2,135	29	2,164	1,408
Level 3 transfers out	(1,015)	(3)	(1,018)	(672)	(1,020)	(113)	(1,133)	(1,052)
Issuances	371		371		3		3	35
Purchases	1,789	19	1,808	412	1,298	42	1,340	600
Settlements	(161)		(161)	(423)	(758)		(758)	(610)
Sales	(2,354)	(301)	(2,655)	(323)	(624)	(382)	(1,006)	(87)
Foreign exchange and other adjustments	(16)	(2)	(18)	5	49	9	58	57
At 31 December	2,790	498	3,288	2,185	4,111	426	4,537	2,997
Amounts recorded in the income statement in respect of balances held at year end								
- unrealised	(84)	4	(80)	595	29	11	40	13
- realised	276		276	(100)	282	(4)	278	(34)

Notes:

(1) There were £240 million net losses on HFT instruments (2016 - £45 million) recorded in income from trading activities in continuing operations. Net gains on other instruments of £9 million (2016 - £4 million losses) were recorded in other operating income and interest income as appropriate in continuing operations. There were no losses in discontinued operations.

(2) Fair value through profit or loss comprises held-for-trading predominantly and designated at fair value through profit and loss.

Notes on the consolidated accounts

9 Financial instruments: fair value of financial instruments not carried at fair value

The following table shows the carrying value and fair value of financial instruments carried at amortised cost on the balance sheet.

	Items where fair value approximates carrying value		Fair value	Fair value of hierarchy level		
	£bn	£bn		Level 1	Level 2	Level 3
2017	£bn	£bn	£bn	£bn	£bn	£bn
Financial assets						
Cash and balances at central banks	98.3					
Loans and advances to banks	1.0	10.5	10.5		9.1	1.4
Loans and advances to customers						
UK PBB						
- mortgages		136.6	136.6			136.6
- other		25.1	24.7			24.7
Ulster Bank Rol						
- mortgages		14.5	12.8			12.8
- other		5.0	5.0			5.0
Commercial Banking						
- commercial real estate		15.9	15.7			15.7
- other		81.1	80.2		0.1	80.1
Private Banking		13.5	13.4			13.4
RBS International		8.7	8.6			8.6
NatWest Markets		9.6	9.7		1.2	8.5
Central items & other		0.1	0.1			0.1
Total loans and advances to customers		310.1	306.8		1.3	305.5
Of which:						
Performing		303.9	300.8		1.3	299.5
Non-performing		6.2	6.0			6.0
Debt securities		7.8	7.9	4.3	1.5	2.1
Settlement balances	2.5					
Financial liabilities						
Deposits by banks	4.5	25.9	26.0		22.4	3.6
Customer accounts	321.5	39.8	39.9		12.9	27.0

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Debt securities in issue		26.0	27.3	22.2	5.1
Settlement balances	2.8				
Notes in circulation (1)	2.2				
Subordinated liabilities		11.8	12.6	12.5	0.1

Note:

(1) Included in Accruals and other liabilities.

Notes on the consolidated accounts

9 Financial instruments - fair value of financial instruments not carried at fair value *continued*

	Items where fair value		Fair value of hierarchy level			
	approximates carrying value	Carrying value	Fair value	Level 1	Level 2	Level 3
	£bn	£bn	£bn	£bn	£bn	£bn
2016*						
Financial assets						
Cash and balances at central banks	74.3					
Loans and advances to banks	0.8	11.4	11.5		3.3	8.2
Loans and advances to customers						
UK PBB						
- mortgages		137.5	138.4			138.4
- other		15.2	14.7			14.7
Ulster Bank Rol						
- mortgages		14.4	12.3			12.3
- other		4.5	4.5			4.5
Commercial Banking						
- commercial real estate		16.6	16.4			16.4
- other		83.7	84.4		0.1	84.3
Private Banking		12.2	12.2			12.2
RBS International		8.5	8.3			8.3
NatWest Markets		13.1	12.7		0.8	11.9
Central items & other		2.1	2.1			2.1
Total loans and advances to customers		307.8	306.0		0.9	305.1
Of which:						
Performing		300.4	298.8		0.9	297.9
Non-performing		7.4	7.2			7.2
Debt securities		8.7	8.8	5.0	0.3	3.5
Settlement balances	5.5					
Financial liabilities						
Deposits by banks	4.3	9.4	9.5		6.2	3.3
Customer accounts	308.4	35.1	35.2		10.9	24.3
Debt securities in issue		21.0	21.6		17.1	4.5
Settlement balances	3.6					
Notes in circulation (1)	2.0					
Subordinated liabilities		18.5	18.5		18.4	0.1

* Re-presented to reflect segment reorganisation.

Note:

(1) Included in Accruals and other liabilities.

Notes on the consolidated accounts

9 Financial instruments: fair value of financial instruments not carried at fair value [continued](#)

The fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Quoted market values are used where available; otherwise, fair values have been estimated based on discounted expected future cash flows and other valuation techniques. These techniques involve uncertainties and require assumptions and judgments covering prepayments, credit risk and discount rates. Furthermore there is a wide range of potential valuation techniques. Changes in these assumptions would significantly affect estimated fair values. The fair values reported would not necessarily be realised in an immediate sale or settlement.

The assumptions and methodologies underlying the calculation of fair values of financial instruments at the balance sheet date are as follows:

Short-term financial instruments

For certain short-term financial instruments: cash and balances at central banks, items in the course of collection from other banks, settlement balances, items in the course of transmission to other banks, customer demand deposits and notes in circulation, carrying value is a reasonable approximation of fair value.

Loans and advances to banks and customers

In estimating the fair value of loans and advances to banks and customers measured at amortised cost, RBS's loans are segregated into appropriate portfolios reflecting the characteristics of the constituent loans. Two principal methods are used to estimate fair value:

(a) Contractual cash flows are discounted using a market discount rate that incorporates the current spread for the borrower or where this is not observable, the spread for borrowers of a similar credit standing. This method is used for portfolios where counterparties have external ratings: institutional and corporate lending in NatWest Markets.

(b) Expected cash flows (unadjusted for credit losses) are discounted at the current offer rate for the same or similar products. This approach is adopted for lending portfolios in UK PBB, Ulster Bank RoI, Commercial Banking (SME loans) and Private Banking in order to reflect the homogeneous nature of these portfolios.

For certain portfolios where there are very few or no recent transactions, such as Ulster Bank RoI's portfolio of lifetime tracker mortgages, a bespoke approach is used.

Debt securities

The majority of debt securities are valued using quoted prices in active markets, or using quoted prices for similar assets in active markets. Fair values of the rest are determined using discounted cash flow valuation techniques.

Deposits by banks and customer accounts

Fair values of deposits are estimated using discounted cash flow valuation techniques.

Debt securities in issue and subordinated liabilities

Fair values are determined using quoted prices for similar liabilities where available or by reference to valuation techniques, adjusting for own credit spreads where appropriate.

10 Financial instruments - maturity analysis**Remaining maturity**

The following table shows the residual maturity of financial instruments, based on contractual date of maturity.

	2017		Total £m	2016		Total £m
	Less than 12 months £m	More than 12 months £m		Less than 12 months £m	More than 12 months £m	
Assets						
Cash and balances at central banks	98,337		98,337	74,250		74,250
Loans and advances to banks	30,153	98	30,251	30,078	60	30,138
Loans and advances to customers	108,990	240,929	349,919	115,925	236,025	351,950
Debt securities	17,204	61,729	78,933	19,530	52,992	72,522
Equity shares		450	450		703	703
Settlement balances	2,517		2,517	5,526		5,526
Derivatives	32,372	128,471	160,843	61,719	185,262	246,981
Liabilities						
Deposits by banks	27,303	19,595	46,898	32,043	6,513	38,556
Customer accounts	394,587	3,449	398,036	377,328	3,640	380,968
Debt securities in issue	7,940	22,619	30,559	6,689	20,556	27,245
Settlement balances and short positions	4,938	26,433	31,371	5,010	20,712	25,722
Derivatives	32,212	122,294	154,506	60,878	175,597	236,475
Subordinated liabilities	2,383	10,339	12,722	1,062	18,357	19,419

Notes on the consolidated accounts

10 Financial instruments maturity analysis continued

Assets and liabilities by contractual cash flow maturity

The tables below show the contractual undiscounted cash flows receivable and payable, up to a period of 20 years, including future receipts and payments of interest of financial assets and liabilities by contractual maturity. The balances in the following tables do not agree directly with the consolidated balance sheet, as the tables include all cash flows relating to principal and future coupon payments, presented on an undiscounted basis. The tables have been prepared on the following basis:

Financial assets have been reflected in the time band of the latest date on which they could be repaid, unless earlier repayment can be demanded by RBS. Financial liabilities are included at the earliest date on which the counterparty can require repayment, regardless of whether or not such early repayment results in a penalty. If the repayment of a financial instrument is triggered by, or is subject to, specific criteria such as market price hurdles being reached, the asset is included in the time band that contains the latest date on which it can be repaid, regardless of early repayment.

The liability is included in the time band that contains the earliest possible date on which the conditions could be fulfilled, without considering the probability of the conditions being met.

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

The principal amounts of financial assets and liabilities that are repayable after 20 years or where the counterparty has no right to repayment of the principal are excluded from the table, as are interest payments after 20 years.

Held-for-trading assets of £243.9 billion (2016 - £328.9 billion) and liabilities of £232.9 billion (2016 - £317.0 billion) have been excluded from the following tables.

2017	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
Assets by contractual maturity						
Cash and balances at central banks	98,337					
Loans and advances to banks	10,792	633	94			

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Debt securities	3,675	5,889	11,960	11,312	12,813	3,638
Settlement balances	2,517					
Total maturing assets	115,321	6,522	12,054	11,312	12,813	3,638
Loans and advances to customers	45,898	32,031	65,077	52,016	68,500	81,995
Derivatives held for hedging	281	832	1,336	334	166	111
	161,500	39,385	78,467	63,662	81,479	85,744
Liabilities by contractual maturity						
Deposits by banks	9,180	1,740	3,614	16,023	61	71
Debt securities in issue	4,106	4,322	10,474	3,731	9,762	49
Subordinated liabilities	87	2,645	1,515	1,620	7,746	2,582
Settlement balances and other liabilities	5,030					
Total maturing liabilities	18,403	8,707	15,603	21,374	17,569	2,702
Customer accounts	356,594	4,298	1,218	77	20	28
Derivatives held for hedging	212	289	1,188	526	813	738
	375,209	13,294	18,009	21,977	18,402	3,468
Maturity gap	96,918	(2,185)	(3,549)	(10,062)	(4,756)	936
Cumulative maturity gap	96,918	94,733	91,184	81,122	76,366	77,302
Guarantees and commitments notional amount						
Guarantees (1)	7,718					
Commitments (2)	121,229					
	128,947					

For the notes to this table refer to following page.

Notes on the consolidated accounts

10 Financial instruments maturity analysis continued

	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
2016						
Assets by contractual maturity						
Cash and balances at central banks	73,822	428				
Loans and advances to banks	11,753	438	47			
Debt securities	4,999	5,424	11,262	8,567	13,541	3,291
Settlement balances	5,526					
Total maturing assets	96,100	6,290	11,309	8,567	13,541	3,291
Loans and advances to customers	47,915	33,443	65,027	52,675	65,427	77,710
Derivatives held for hedging	455	1,178	2,319	531	337	125
	144,470	40,911	78,655	61,773	79,305	81,126
Liabilities by contractual maturity						
Deposits by banks	7,205	33	1,285	5,050	78	79
Debt securities in issue	2,269	4,537	7,239	5,381	7,604	798
Subordinated liabilities	996	966	4,835	2,638	12,421	2,532
Settlement balances and other liabilities	5,673					
Total maturing liabilities	16,143	5,536	13,359	13,069	20,103	3,409
Customer accounts	338,436	4,943	1,484	149	51	35
Derivatives held for hedging	205	405	1,329	584	854	857
	354,784	10,884	16,172	13,802	21,008	4,301
Maturity gap	79,957	754	(2,050)	(4,502)	(6,562)	(118)
Cumulative maturity gap	79,957	80,711	78,661	74,159	67,597	67,479
Guarantees and commitments notional amount						
Guarantees (1)	7,867					
Commitments (2)	134,324					
	142,191					

Notes:

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

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

11 Financial assets - impairments

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

	Individually assessed £m	Collectively assessed £m	Latent £m	2017 £m	2016 £m
At 1 January	1,395	2,660	400	4,455	7,119
Currency translation and other adjustments	(39)	9	4	(26)	500
Disposals	(5)			(5)	(2)
Amounts written-off	(453)	(757)		(1,210)	(3,695)
Recoveries of amounts previously written-off	29	127		156	109
Losses/(releases) to income statement	229	315	(14)	530	537
Unwind of discount (recognised in interest income)	(24)	(62)		(86)	(113)
At 31 December (1)	1,132	2,292	390	3,814	4,455

Notes:

(1) Includes nil relating to loans and advances to banks (2016 - nil).

(2) The table above excludes impairments relating to securities.

	2017 £m	2016 £m	2015 £m
Impairment losses/(releases) charged to the income statement			
Loans and advances to customers	530	537	(849)
Loans and advances to banks			(4)
Securities	530	537	(853)
	(37)	(59)	126
	493	478	(727)

Notes on the consolidated accounts

11 Financial assets - impairments *continued*

The following tables analyse impaired financial assets.

	2017			2016		
	Cost £m	Provision £m	Carrying value £m	Cost £m	Provision £m	Carrying value £m
Loans and receivables						
Loans and advances to customers (1)	7,423	3,424	3,999	8,865	4,055	4,810

Note:

- (1) Impairment provisions individually assessed on balances of £3,418 million (2016 - £4,186 million).

	Carrying value	
	2017 £m	2016 £m
Available-for-sale securities		
Debt securities	2	33
Equity shares	20	23
Loans and receivables		
Debt securities	1	2
	23	58

Financial and non-financial assets recognised on the balance sheet, obtained during the year by taking possession of collateral or calling on other credit enhancements, were £30 million (2016 - £30 million).

In general, RBS seeks to dispose of property and other assets not readily convertible into cash, obtained by taking possession of collateral, as rapidly as the market for the individual asset permits.

12 Derivatives

Companies within RBS transact derivatives as principal either as a trading activity or to manage balance sheet foreign exchange, interest rate and credit risk.

RBS enters into fair value hedges, cash flow hedges and hedges of net investments in foreign operations. The majority of RBS's interest rate hedges relate to the management of RBS's non-trading interest rate risk. RBS manages this risk within approved limits. Residual risk positions are hedged with derivatives principally interest rate swaps. Suitable larger financial instruments are fair value hedged; the remaining exposure, where possible, is hedged by derivatives documented as cash flow hedges and qualifying for hedge accounting. The majority of RBS's fair value hedges involve interest rate swaps hedging the interest rate risk in recognised financial assets and financial liabilities. Cash flow hedges relate to exposures to the variability in future interest payments and receipts on forecast transactions and on recognised financial assets and financial liabilities. RBS hedges its net investments in foreign operations with currency borrowings and forward foreign exchange contracts.

For cash flow hedge relationships of interest rate risk, the hedged items are actual and forecast variable interest rate cash flows arising from financial assets and financial liabilities with interest rates linked to LIBOR, EURIBOR or the Bank of England Official Bank Rate. The financial assets are customer loans and the financial liabilities are customer deposits and LIBOR linked medium-term notes and other issued securities. At 31 December 2017 variable rate financial assets of £91 billion (2016 - £81 billion) and variable rate financial liabilities of £69 billion (2016 - £55 billion) were hedged in such cash flow hedge relationships.

For cash flow hedging relationships, the initial and ongoing effectiveness is assessed by comparing movements in the fair value of the expected highly probable forecast interest cash flows with movements in the fair value of the expected changes in cash flows from the hedging interest rate swap. Hedge effectiveness is measured on a cumulative basis over a time period management feels appropriate. The method of calculating hedge ineffectiveness is the hypothetical derivative method.

For fair value hedge relationships of interest rate risk, the hedged items are typically large corporate fixed-rate loans, government securities, fixed rate finance leases, fixed rate medium-term notes or preference shares classified as debt. At 31 December 2017, fixed rate financial assets of £36 billion (2016 - £29 billion) and fixed rate financial liabilities of £22 billion (2016 - £23 billion) were hedged by interest rate swaps in fair value hedge relationships.

The initial and ongoing effectiveness of fair value hedge relationships is assessed on a cumulative basis by comparing movements in the fair value of the hedged item attributable to the hedged risk with changes in the fair value of the hedging interest rate swap over a time period management feels is appropriate.

Notes on the consolidated accounts

12 Derivatives continued

	2017			2016		
	Notional amount £bn	Assets £m	Liabilities £m	Notional amount £bn	Assets £m	Liabilities £m
Exchange rate contracts						
Spot, forwards and futures	1,900	19,283	19,172	2,271	35,817	33,986
Currency swaps	666	11,163	13,534	821	22,139	25,053
Options purchased	419	8,765		670	17,486	
Options written	440		8,975	683		18,109
Interest rate contracts						
Interest rate swaps	8,058	99,065	91,025	11,523	139,004	127,151
Options purchased	1,162	21,733		1,518	31,457	
Options written	1,032		21,021	1,181		31,298
Futures and forwards	1,764	147	114	2,403	63	36
Credit derivatives	38	531	558	42	682	557
Equity and commodity contracts	3	156	107	21	333	285
		160,843	154,506		246,981	236,475

Included in the table above are derivatives held for hedging purposes as follows:

	2017		2016	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Fair value hedging				
Interest rate contracts	904	2,211	1,365	2,612
Cash flow hedging				
Interest rate contracts	1,989	1,295	3,079	1,419
Exchange rate contracts	63	37	259	
Net investment hedging				
Exchange rate contracts	11	28	86	26
	2,967	3,571	4,789	4,057

Hedge ineffectiveness recognised in other operating income in continuing operations comprised:

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	2017	2016	2015
	£m	£m	£m
Fair value hedging			
(Losses)/gains on the hedged items attributable to the hedged risk	(48)	1,146	110
Gains/(losses) on the hedging instruments	78	(1,117)	(39)
Fair value hedging ineffectiveness	30	29	71
Cash flow hedging ineffectiveness	9	(29)	(23)
	39		48

Substantially all forecast receivable hedged cash flows occur within 5 years (2016 - 5 years) and substantially all forecast payable cash flows occur within 10 years (2016 - 10 years); the income statement is impacted over the same periods.

Notes on the consolidated accounts

13 Debt securities

	Central and local government			Other financial			Total	Of which ABS (1)
	UK £m	US £m	Other £m	Banks £m	institutions £m	Corporate £m		
2017								
Held-for-trading	3,514	3,667	14,736	1,844	2,746	974	27,481	870
Designated as at fair value through profit or loss								
Available-for-sale	17,656	8,461	11,454	2,218	3,784	108	43,681	1,826
Loans and receivables					3,501	142	3,643	3,500
Held-to-maturity	4,128						4,128	
	25,298	12,128	26,190	4,062	10,031	1,224	78,933	6,196
Available-for-sale								
Gross unrealised gains	703	67	324	8	24	1	1,127	12
Gross unrealised losses	(19)	(70)	(16)	(4)	(7)	(1)	(117)	
2016								
Held-for-trading	2,615	4,133	14,087	821	2,299	549	24,504	886
Designated as at fair value through profit or loss			25		2		27	
Available-for-sale	10,581	6,953	15,678	1,852	4,072	118	39,254	2,263
Loans and receivables					3,774	194	3,968	3,814
Held-to-maturity	4,769						4,769	
	17,965	11,086	29,790	2,673	10,147	861	72,522	6,963
Available-for-sale								
Gross unrealised gains	768	56	504	8	93	2	1,431	75
Gross unrealised losses	(16)	(123)	(13)	(1)	(43)	(2)	(198)	(32)

Note:

(1) Includes covered bonds.

Gross gains of £58 million (2016 - £115 million) and gross losses of £12 million (2016 - £107 million) were realised on the sale of available-for-sale securities in continuing operations.

There were no gross gains or losses in discontinued operations in 2017 or 2016.

The following table analyses available-for-sale debt securities and the related yield (based on weighted averages) by remaining maturity and issuer.

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	0-1 years		1-5 years		5-10 years		Over 10 years		Total	
	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %
2017										
Central and local governments										
- UK	1,152	1.7	7,000	2.5	5,814	2.0	3,690	3.2	17,656	2.4
- US	455	0.8	4,243	1.9	2,221	2.1	1,542	2.8	8,461	2.1
- other	4,716	0.7	3,405	1.5	2,230	1.1	1,103	2.6	11,454	1.2
Banks	619	0.6	1,287	0.9	312	0.6			2,218	0.8
Other financial institutions	987	1.2	1,983	1.1	491	1.0	323	0.4	3,784	1.1
Corporate	26	1.9	63	1.9	19	1.0			108	1.8
	7,955	0.9	17,981	1.9	11,087	1.7	6,658	2.9	43,681	1.8
Of which ABS (1)	263	0.4	1,009	0.5	231	-	323	0.1	1,826	0.4
2016										
Central and local governments										
- UK	1,722	0.9	2,900	5.2	3,318	3.5	2,641	3.0	10,581	3.4
- US	41	1.9	2,797	1.9	2,799	2.1	1,316	3.0	6,953	2.2
- other	5,104	1.1	5,942	1.0	3,444	1.2	1,188	2.4	15,678	1.2
Banks	798	0.5	965	0.4	89	0.3			1,852	0.5
Other financial institutions	451	1.1	2,282	1.1	848	0.9	491	0.3	4,072	1.0
Corporate	27	0.7	56	0.7	35	0.7			118	0.7
	8,143	1.0	14,942	2.0	10,533	2.1	5,636	2.6	39,254	1.9
Of which ABS (1)	377	0.8	974	0.5	415		497		2,263	0.3

Note:

(1) Includes covered bonds.

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14 Equity shares

	2017			2016		
	Listed £m	Unlisted £m	Total £m	Listed £m	Unlisted £m	Total £m
Held-for-trading	7	22	29	106	60	166
Designated as at fair value through profit or loss	6	128	134	3	169	172
Available-for-sale	35	252	287	30	335	365
	48	402	450	139	564	703
Available-for-sale						
Gross unrealised gains	20	47	67	13	48	61
Gross unrealised losses		(8)	(8)		(8)	(8)
	20	39	59	13	40	53

Gross gains of £89 million (2016 - £73 million) and gross losses of £1 million (2016 - £10 million) were realised on the sale of available-for-sale equity shares in continuing operations. There were no gains or losses in discontinued operations.

Dividend income from available-for-sale equity shares was £13 million (2016 - £13 million) in continuing operations and nil (2016 - nil) in discontinued operations.

Unquoted equity investments whose fair value cannot be reliably measured are carried at cost and classified as available-for-sale financial assets. Unquoted equity shares generated no material gains or losses in 2017 or 2016.

15 Intangible assets

	2017			2016		
	Goodwill £m	Other (1) £m	Total £m	Goodwill £m	Other (1) £m	Total £m
At 1 January	17,756	2,095	19,851	16,483	2,190	18,673
Currency translation and other adjustments	283	(3)	280	1,273	76	1,349
Additions		384	384		480	480
Disposals and write-off of fully amortised assets		(217)	(217)		(651)	(651)
At 31 December	18,039	2,259	20,298	17,756	2,095	19,851
Accumulated amortisation and impairment						
At 1 January	12,198	1,173	13,371	10,925	1,211	12,136

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Currency translation and other adjustments	283	(5)	278	1,273	70	1,343
Disposals and write-off of fully amortised assets		(145)	(145)		(471)	(471)
Charge for the year		222	222		204	204
Write down of goodwill and other intangible assets		29	29		159	159
At 31 December	12,481	1,274	13,755	12,198	1,173	13,371
Net book value at 31 December	5,558	985	6,543	5,558	922	6,480

Note:

(1) Principally internally generated software.

The Group's goodwill acquired in business combinations is reviewed annually at 31 December for impairment.

Impairment testing involves the comparison of the carrying value of each cash-generating unit (CGU) with its recoverable amount. The carrying values of the segments reflect the equity allocations made by management which are consistent with the Group's capital targets. Recoverable amount is the higher of fair value and value in use. Value in use is the present value of expected future cash flows from the CGU. Fair value is the price that would be received to sell an asset in an orderly transaction between market participants.

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 CGUs; and the valuation of the separable assets of each business whose goodwill is being reviewed.

The impact of sensitivity to the more significant variables in each assessment is presented in the tables on the following page.

The recoverable amounts for all CGUs at 31 December 2017 were based on value in use, using management's latest five-year revenue and cost forecasts. The long-term growth rates have been based on expected nominal growth of the CGUs. The pre-tax risk discount rates are based on those observed to be applied to businesses regarded as peers of the CGUs.

The annual review at 31 December 2017 indicated no impairment to goodwill.

The analysis of goodwill by reportable segment is shown in Note 37.

Notes on the consolidated accounts

15 Intangible assets *continued*

The carrying value of goodwill and the amount by which it is exceeded by the recoverable amount are set out below by reportable segment, along with the key assumptions applied in calculating the recoverable amount and sensitivities to changes in those assumptions. The recoverable amount of UK Personal & Business Banking, Commercial Banking and RBS International were £21.6 billion (2016 - £23.9 billion), £13.7 billion (2016 - £14.1 billion) and £3.3 billion (2016 - £2.7 billion) respectively.

	Assumptions			Recoverable amount exceeded carrying value	Consequential impact of 1%		Consequential impact of 5%		Break even discount rate
	Goodwill	Terminal growth rate	Pre-tax discount rate		Discount rate	Terminal growth rate	Forecast Income	Forecast cost	
31 December 2017	£bn	%	%	£bn	£bn	£bn	£bn	£bn	%
UK Personal & Business Banking	3.4	2.0	13.1	9.7	(1.8)	(1.2)	(1.3)	(0.6)	21.6
Commercial Banking	1.9	2.0	12.9	1.3	(1.2)	(0.8)	(0.7)	(0.4)	13.9
RBS International	0.3	2.0	11.0	0.6	(0.4)	(0.3)	(0.1)		12.8
31 December 2016									
UK Personal & Business Banking	3.4	2.5	12.8	14.6	(2.3)	(1.5)	(1.2)	(0.6)	27.0
Commercial Banking	1.9	2.5	12.9	2.1	(1.2)	(0.8)	(0.7)	(0.4)	14.7
RBS International	0.3	2.5	10.9	0.2	(0.3)	(0.2)	(0.1)		11.7

Other intangible assets are reviewed for indicators of impairment. In 2017 £29 million (2016 - £159 million) of previously capitalised software was impaired primarily as a result of software which is no longer expected to derive future economic benefit.

16 Property, plant and equipment

	Investment properties	Freehold premises	Long leasehold premises	Short leasehold premises	Computers and other equipment	Operating lease assets	Total
	£m	£m	£m	£m	£m	£m	£m
2017							
<i>Cost or valuation</i>							
At 1 January	1,095	2,736	152	1,247	2,467	1,313	9,010
Transfers to disposal groups		(405)	(10)	(1)	(21)		(437)
Currency translation and other adjustments	18	(36)			(17)	(1)	(36)
Reclassifications		109		(109)			
Additions	8	691	5	66	148	199	1,117
Change in fair value of investment properties	(14)						(14)
Disposals and write-off of fully depreciated assets	(14)	(80)	(14)	(218)	(208)	(447)	(981)
At 31 December	1,093	3,015	133	985	2,369	1,064	8,659

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Accumulated impairment, depreciation and amortisation

At 1 January	1,177	72	799	1,784	588	4,420	
Transfers to disposal groups	(223)	(5)	(1)	(18)		(247)	
Currency translation and other adjustments	(35)			(18)		(53)	
Reclassifications	57		(57)				
Write down of property, plant and equipment	122			3		125	
Disposals and write-off of fully depreciated assets	(34)	(14)	(176)	(159)	(266)	(649)	
Charge for the year	88	5	64	161	143	461	
At 31 December	1,152	58	629	1,753	465	4,057	
Net book value at 31 December	1,093	1,863	75	356	616	599	4,602

Notes on the consolidated accounts

16 Property, plant and equipment *continued*

	Investment properties	Freehold premises	Long leasehold premises	Short leasehold premises	Computers and other equipment	Operating lease assets	Total
	£m	£m	£m	£m	£m	£m	£m
2016							
Cost or valuation							
At 1 January	915	2,559	177	1,259	2,305	1,556	8,771
Currency translation and other adjustments	140	91	5	73	108	25	442
Reclassifications		46		(46)			
Additions	103	215	5	79	282	228	912
Change in fair value of investment properties	(11)						(11)
Disposals and write-off of fully depreciated assets	(52)	(175)	(35)	(118)	(228)	(496)	(1,104)
At 31 December	1,095	2,736	152	1,247	2,467	1,313	9,010
Accumulated impairment, depreciation and amortisation							
At 1 January		1,090	87	759	1,677	676	4,289
Currency translation and other adjustments		70	3	53	97	9	232
Reclassifications		9		(9)			
Write down of property, plant and equipment		71			7		78
Disposals and write-off of fully depreciated assets		(137)	(22)	(86)	(180)	(250)	(675)
Charge for the year		74	4	82	183	153	496
At 31 December		1,177	72	799	1,784	588	4,420
Net book value at 31 December	1,095	1,559	80	448	683	725	4,590

Investment property valuations principally employ present value techniques that discount expected cash flows. Expected cash flows reflect rental income, occupancy and residual market values; valuations are sensitive to changes in these factors. The fair value measurement of non-specialised properties in locations where the market for such properties is active and transparent are categorised as level 2 - 2% (2016 - 2%); otherwise investment property fair value measurements are categorised as level 3 - 98% (2016 - 98%). A 5% change in the most sensitive assumption, residual values, is £40 million.

Valuations were carried out by qualified surveyors who are members of the Royal Institution of Chartered Surveyors, or an equivalent overseas body; property with a fair value of £201 million (2016 - £222 million) was valued by independent valuers.

Rental income from investment properties was £84 million (2016 - £79 million). Direct operating expenses of investment properties in continuing operations were £9 million (2016 - £16 million).

17 Prepayments, accrued income and other assets

2017
£m

2016
£m

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Prepayments	392	350
Accrued income	378	412
Interests in associates (1)	1,410	1,509
Pension schemes in net surplus (refer to Note 4)	392	276
Tax recoverable	27	71
Other assets	1,127	1,082
	3,726	3,700

Note:

(1) Interests in associates includes interest in Alawwal Bank £1,052 million (2016 - £1,083 million) and Business Growth Fund £316 million (2016 - £256 million).

Notes on the consolidated accounts

18 Discontinued operations and assets and liabilities of disposal groups

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

	2017 £m	2016 £m	2015 £m
Citizens			
Interest receivable			1,433
Interest payable			(144)
Net interest income			1,289
Non-interest income			615
Total income			1,904
Operating expenses			(1,181)
Profit before impairment losses			723
Impairment losses			(103)
Operating profit before tax			620
Tax charge			(212)
Profit after tax			408
Provision for gain on disposal of subsidiary			10
Gain on disposal of subsidiary			1,147
Provision for loss on disposal of interest in associate			(130)
Gain on disposal of interest in associate			90
Profit from Citizens discontinued operation, net of tax			1,525
Other			
Profit from other discontinued operations, net of tax			16
Total profit from discontinued operations, net of tax			1,541

RBS sold the final tranche of its interest in Citizens Financial Group, Inc (Citizens) during October 2015. Consequently, Citizens was classified as a disposal group at 31 December 2014 and presented as a discontinued operation until October 2015. From 3 August 2015 until the final tranche was sold in October 2015, Citizens was an associated undertaking.

The gain on disposal in 2015 in relation to Citizens comprised £248 million on the derecognition of assets and liabilities, and £989 million in respect of reserves reclassified in accordance with IFRS.

There was no profit from discontinued operations attributable to non-controlling interests (2016 - nil; 2015 - £334 million).

(b) Operating cash flows attributable to discontinued operations

Included within the Group's cash flows are the following amounts attributable to discontinued operations:

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	2017	2016	2015
	£m	£m	£m
Net cash flows from operating activities			(57)
Net cash flows from investing activities			(6)
Net cash flows from financing activities			10
Net decrease in cash and cash equivalents			(58)

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Notes on the consolidated accounts

18 Discontinued operations and assets and liabilities of disposal groups *continued*

(c) Assets and liabilities of disposal groups

	2017 £m	2016 £m
Assets of disposal groups		
Loans and advances to banks	10	13
Property, plant and equipment	185	13
	195	
Liabilities of disposal groups		
Other liabilities	10	15
	10	15

19 Short positions

	2017 £m	2016 £m
Debt securities		
- Government	26,381	20,979
- Other issuers	2,145	1,095
Equity shares	1	3
	28,527	22,077

Note:

(1) All short positions are classified as held-for-trading.

20 Provisions for liabilities and charges

	Payment protection insurance (1) £m	Other customer redress £m	Residential mortgage backed securities (2) £m	Litigation and other regulatory (3) £m	Property and other (4) (5) £m	Total £m
Provisions for liabilities and charges						

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At 1 January 2017	1,253	1,105	6,752	1,918	1,808	12,836
Currency translation and other movements		4	(541)	(31)	35	(533)
Charge to income statement	175	228	714	280	1,003	2,400
Releases to income statement		(54)	(50)	(156)	(209)	(469)
Provisions utilised	(375)	(413)	(3,632)	(1,370)	(687)	(6,477)
At 31 December 2017	1,053	870	3,243	641	1,950	7,757

Notes:

(1) To reflect the increased volume of complaints following the FCA's introduction of an August 2019 PPI timebar as outlined in FCA announcement CP17/3 and the introduction of new Plevin (unfair commission) complaint handling rules, RBS increased its provision for PPI by £175m in 2017 (2016 - £601 million, 2015 - £600 million, 2014 - £650 million) bringing the cumulative charge to £5.1 billion, of which £3.7 billion (74%) in redress and £0.4 billion in administrative expenses had been paid by 31 December 2017. Of the £5.1 billion cumulative charge, £4.6 billion relates to redress and £0.5 billion to administrative expenses.

The principal assumptions underlying RBS's provision in respect of PPI sales are: assessment of the total number of complaints that RBS will receive before 29 August 2019; the proportion of these that will result in redress; and the average cost of such redress. The number of complaints has been estimated from an analysis of RBS's portfolio of PPI policies sold by vintage and by product. Estimates of the percentage of policyholders that will lodge complaints (the take up rate) and of the number of these that will be upheld (the uphold rate) have been established based on recent experience, guidance in FCA policy statements and the expected rate of responses from proactive customer contact. The average redress assumption is based on recent experience and FCA calculation rules. The table below shows the sensitivity of the provision to changes in the principal assumptions (all other assumptions remaining the same).

Assumptions	Actual to date	Future expected	Sensitivity	
			Change in assumption %	Consequential change in provision £m
Customer initiated complaints (1)	2,386k	429k	+/- 5	+/- 30
Uphold rate (2)	90%	94%	+/- 1	+/- 6
Average redress (3)	£1,681	£1,476	+/- 5	+/- 30
Processing costs per claim (4)	£160	£142	+/- £20	+/- 3

Notes:

(1) Claims received directly by RBS to date, including those received via CMCs and Plevin (commission) only. Excluding those for proactive mailings and where no PPI policy exists.

(2) Average uphold rate per customer initiated claims received directly by RBS to end of timebar for both PPI (mis-sale) and Plevin (commission), excluding those for which no PPI policy exists.

(3) Average redress for PPI (mis-sale) and Plevin (commission) pay-outs.

(4) Processing costs per claim on a valid complaints basis, includes direct staff costs and associated overhead - excluding FOS fees.

Notes on the consolidated accounts

20 Provisions for liabilities and charges *continued*

Interest that will be payable on successful complaints has been included in the provision as has the estimated cost to RBS of administering the redress process. There are uncertainties as to the eventual cost of redress which will depend on actual complaint volumes, take up and uphold rates and average redress costs. Assumptions related to these are inherently uncertain and the ultimate financial impact may be different from the amount provided. We continue to monitor the position closely and refresh the underlying assumptions.

Background information in relation to PPI claims is given in Note 31.

(2) In the US, RBS is subject to civil litigation and various investigations relating to its issuance and underwriting of US mortgage-backed securities (RMBS). An additional charge of US\$650 million (£492 million) was taken in Q4 2017 in connection with these matters, resulting in a year to date charge of US\$971 million (£714 million). Detailed descriptions of RBS's legal proceedings and discussion of the associated uncertainties are given in Note 31.

In July 2017, RBS reached a settlement with the Federal Housing Finance Agency (FHFA) as conservator of Fannie Mae and Freddie Mac, to resolve claims by FHFA in relation to RBS's issuance and underwriting of approximately US\$32 billion (£25 billion) of RMBS in the US. As part of the settlement, FHFA's outstanding litigation against RBS relating to those securities was withdrawn.

Under the settlement, RBS paid FHFA US\$5.5 billion (£4.2 billion), of which US\$754 million (£581 million) was reimbursed to RBS under indemnification agreements with third parties. The cost to RBS (net of the indemnity mentioned above) of US\$4.75 billion (£3.65 billion) was largely covered by then-existing provisions but an incremental charge of US\$196 million (£151 million) was recorded in Q2 2017 in relation to the settlement.

(3) RBS is party to certain legal proceedings and regulatory investigations and continues to co-operate with a number of regulators. All such matters are periodically reassessed with the assistance of external professional advisers, where appropriate, to determine the likelihood of RBS incurring a liability and to evaluate the extent to which a reliable estimate of any liability can be made. Details of these investigations and a discussion of the nature of the associated uncertainties are given in Note 31.

(4) RBS recognised a £750 million provision in 2016 as a consequence of the announcement that HM Treasury is seeking a revised package of remedies that would conclude its remaining State Aid commitments. An additional charge of £50 million was taken in Q2 2017 following further revisions to the package, taking the total provision to £800 million.

(5) The majority of property provisions relate to vacant leasehold property and comprise the present value of the shortfall between rentals payable and rentals receivable from sub-letting. In addition to the £800 million provision taken as an estimate of the cost of completing RBS's State Aid divestment commitments as referred to in (4), other provisions include restructuring provisions of £482 million principally in relation to termination benefits.

21 Accruals and other liabilities

	2017	2016
	£m	£m
Notes in circulation	2,186	2,028
Current tax	227	336
Accruals	1,074	1,311
Deferred income	469	483
Other liabilities	2,436	2,833
	6,392	6,991

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Notes on the consolidated accounts

22 Deferred tax

	2017 £m	2016 £m
Deferred tax asset	(1,740)	(1,803)
Deferred tax liability	583	662
Net deferred tax asset	(1,157)	(1,141)

Net deferred tax asset comprised:

	Pension allowances £m	Accelerated capital £m	Provisions £m	Deferred gains £m	Fair value of financial instruments £m	AFS financial assets £m	Intangibles £m	Cash flow hedging schemes £m	Share £m	Tax losses carried forward £m	Other £m	Total £m
At 1 January 2016	(857)	238	(344)	132	21	100	4	253	(23)	(1,332)	59	(1,749)
Acquisitions and disposals of subsidiaries	(1)	(59)		3		4					1	(52)
(Credit)/charge to income statement	(39)	149	25	(22)	1	(24)		(143)	13	317	(51)	226
Charge/(credit) to other comprehensive income	240					(9)		193				424
Currency translation and other adjustments	(5)	33	(3)	1		2	1	(3)		(35)	19	10
At 1 January 2017	(662)	361	(322)	114	22	73	5	300	(10)	(1,050)	28	(1,141)
Acquisitions and disposals of subsidiaries		(29)										(29)
Charge/(credit) to income statement	3	(126)	55	(45)	(52)	(4)		102	1	121	(22)	33
Charge/(credit) to other comprehensive income	266			(19)		23		(266)				4
Currency translation and other adjustments		(14)	1	3						(10)	(4)	(24)
At 31 December 2017	(393)	192	(266)	53	(30)	92	5	136	(9)	(939)	2	(1,157)

Deferred tax assets in respect of unused tax losses are recognised if the losses can be used to offset probable future taxable profits after taking into account the expected reversal of other temporary differences. Recognised deferred tax assets in respect of tax losses are analysed further below.

	2017 £m	2016 £m
UK tax losses carried forward		

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- The Royal Bank of Scotland plc	125	182
- National Westminster Bank Plc	541	605
- Ulster Bank Limited	14	14
Total	680	801
Overseas tax losses carried forward		
- Ulster Bank Ireland DAC	259	249
	939	1,050

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Notes on the consolidated accounts

22 Deferred tax continued

UK tax losses

Under UK tax rules, tax losses can be carried forward indefinitely. In periods from 1 April 2015, the Finance Act 2015 limits the offset of losses carried forward by UK banks to 50% of profits. In periods from 1 April 2016, the Finance Act 2016 further limits the offset of losses carried forward by UK banks to 25% of profits. The main rate of UK Corporation Tax reduced from 20% to 19% from 1 April 2017 and will reduce to 17% from 1 April 2020. Under the Finance (No 2) Act 2015, tax losses arising prior to 1 January 2016 are given credit in future periods at the main rate of UK corporation tax, excluding the Banking Surcharge rate (8%) introduced by the Act. Deferred tax assets and liabilities at 31 December 2017 take into account the reduced rates in respect of tax losses and non-banking temporary differences and where appropriate, the banking surcharge inclusive rate in respect of other banking temporary differences.

The Royal Bank of Scotland plc The Royal Bank of Scotland plc expects that the balance of recognised deferred tax asset at 31 December 2017 of £125 million in respect of tax losses amounting to c. £700 million will be substantially recovered by the end of 2022. Since 2012 RBS has reported mixed levels of taxable profits and losses because core banking profitability was offset by a series of restructuring plans as the group reshaped to meet commercial and regulatory demands. In total, £10,247 million of losses have not been recognised in the deferred tax balance at 31 December 2017; such losses will be available to offset 25% of future taxable profits in excess of those forecast in the closing deferred tax asset.

National Westminster Bank plc A deferred tax asset of £541 million has been recognised in respect of total losses of £3,092 million. The losses arose principally as a result of significant impairment and conduct charges between 2009 and 2012 during challenging economic conditions in the UK banking sector. National Westminster Bank plc returned to tax profitability during 2015 and expects the deferred tax asset to be substantially consumed by future taxable profits by the end of 2024. A reduction in annual profits by £120 million would extend the recovery of the deferred tax asset by one year.

Overseas tax losses

Ulster Bank Ireland DAC A deferred tax asset of £259 million has been recognised in respect of losses of £2,071 million of total tax losses of £8,596 million carried forward at 31 December 2017. The losses arose principally as a result of significant impairment charges between 2008 and 2013 during challenging economic conditions in the Republic of Ireland; subsequent movements reflect £: exchange differences. Ulster Bank Ireland DAC returned to profitability during 2014 and expects the deferred tax asset to be substantially consumed by future taxable profits by the end of 2024.

Unrecognised deferred tax

Deferred tax assets of £6,356 million (2016 - £7,940 million; 2015 - £6,349 million) have not been recognised in respect of tax losses and other temporary differences carried forward of £30,049 million (2016 - £33,376 million; 2015 - £27,483 million) in jurisdictions where doubt exists over the availability of future taxable profits. Of these losses and other temporary differences, £4,335 million expire within five years and £7,208 million

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thereafter. The balance of tax losses and other temporary differences carried forward has no expiry date.

Deferred tax liabilities of £255 million (2016 - £258 million; 2015 - £256 million) have not been recognised in respect of retained earnings of overseas subsidiaries and held-over gains on the incorporation of overseas branches. Retained earnings of overseas subsidiaries are expected to be reinvested indefinitely or remitted to the UK free from further taxation. No taxation is expected to arise in the foreseeable future in respect of held-over gains. Dividends received from overseas are largely exempt from UK tax.

Notes on the consolidated accounts

23 Subordinated liabilities

	2017	2016
	£m	£m
Dated loan capital	10,394	15,288
Undated loan capital	2,169	2,775
Preference shares	159	1,356
	12,722	19,419

Certain preference shares issued by the company are classified as liabilities; these securities remain subject to the capital maintenance rules of the Companies Act 2006.

The following tables analyse the remaining contractual maturity of subordinated liabilities by the final redemption date and by the next call date.

	2018	2019	2020-2022	2023-2027	Thereafter	Perpetual	Total	
2017 - final redemption	£m	£m	£m	£m	£m	£m	£m	
Sterling	16		354			504	874	
US dollar	441	63	1,704	4,037	517	1,183	7,945	
Euro	1,926	145	271	1,037	301	215	3,895	
Other						8	8	
	2,383	208	2,329	5,074	818	1,910	12,722	
	Currently	2018	2019	2020-2022	2023-2027	Thereafter	Perpetual	Total
2017 - call date	£m	£m	£m	£m	£m	£m	£m	£m
Sterling		123	37	466	23	21	204	874
US dollar	15	1,043	63	1,705	4,041	1,078		7,945
Euro		2,084	1,044	271	147	300	49	3,895
Other			8					8
	15	3,250	1,152	2,442	4,211	1,399	253	12,722

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		2017	2018	2019-2021	2022-2026	Thereafter	Perpetual	Total
		£m	£m	£m	£m	£m	£m	£m
2016 - final redemption								
Sterling		17		369			576	962
US dollar		98	700	168	7,955	967	2,479	12,367
Euro		913	1,817	243	1,725	263	215	5,176
Other		34			872		8	914
		1,062	2,517	780	10,552	1,230	3,278	19,419
	Currently	2017	2018	2019-2021	2022-2026	Thereafter	Perpetual	Total
		£m	£m	£m	£m	£m	£m	£m
2016 - call date								
Sterling		15	68	113	407	140	197	962
US dollar		1,860	1,817	700	168	6,242	1,186	12,367
Euro		162	1,395	1,817	1,108	378	263	5,176
Other		8	906					914
		2,045	4,186	2,630	1,683	6,760	1,471	19,419

Notes on the consolidated accounts

23 Subordinated liabilities *continued*

	Capital treatment	2017	2016
	£m	£m	£m
Redemptions			
<i>The Royal Bank of Scotland Group plc</i>			
£200 million series 1 non cumulative convertible £0.01 preference shares 7.387% (partial redemption)	Ineligible	15	
US\$ 1,000 million series 1 non cumulative convertible preference shares of US\$ 0.01 9.118% (partial redemption)	Ineligible	48	
\$156 million 7.65% Series F non-cumulative preference shares (callable)	Ineligible	120	
\$242 million 7.25% Series H non-cumulative preference shares (callable)	Ineligible	186	
\$751 million 5.75% Series L non-cumulative preference shares (callable)	Ineligible	577	
US\$ 750 million 6.8% (partial redemption)	Ineligible	360	
US\$ 1,285 million 5.90% Trust Preferred	Tier 1		902
US\$ 200 million 6.25% Trust Preferred	Tier 1		140
US\$ 1,800 million 6.08% Trust Preferred	Tier 1		1,263
26 million 7.42% dated notes	Tier 2		21
7 million 7.38% dated notes	Tier 2		6
US\$ 25 million floating rate notes (partial redemption)	Tier 2		6
		1,306	2,338
<i>The Royal Bank of Scotland plc</i>			
750 million 4.35% subordinated notes 2017	Tier 2	645	
CHF124 million 9.375% subordinates notes March 2022	Tier 2	101	
CAD420 million 10.50% subordinated notes March 2022	Tier 2	255	
£564 million 10.50% subordinated notes March 2022	Tier 2	489	
AU\$880 million 13.125% subordinated notes March 2022	Tier 2	548	
US\$ 2,132 million 9.50% subordinated notes March 2022	Tier 2	1,724	
100 million floating rate subordinated notes 2017	Tier 2	90	
£51 million 2.35% + 5 year UK Gilts yield undated subordinated notes (callable December 2012)	Ineligible	51	
£54 million 5.13% undated notes	Ineligible		55
CAD474 million 5.37% undated notes	Ineligible		283
1 billion 4.625% dated notes	Ineligible		