

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

FORM 20-F

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

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

For the fiscal year ended 31 December 2004

OR TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number 1-10306

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

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

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

* Issuable upon exchange of the Exchangeable Capital Securities

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

None

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

None

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

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

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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 which financial statement item the registrant has elected to follow.

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SEC Form 20-F cross reference guide

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Operating and financial review

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Presentation of information

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

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

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

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

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

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

Forward-looking statements

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

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

Other factors that could cause actual results to differ materially from those estimated by the forward-looking statements contained in this document include, but are not limited to: general economic conditions in the UK and in other countries in which the Group has significant business activities or investments, including the United States;

the monetary and interest rate policies of the Bank of England, the Board of Governors of the Federal Reserve System and other G-7 central banks; inflation; deflation; unanticipated turbulence in interest rates, foreign currency exchange rates, commodity prices and equity prices; changes in UK and foreign laws, regulations and taxes; changes in competition and pricing environments; natural and other disasters; the inability to hedge certain risks economically; the adequacy of loss reserves; acquisitions or restructurings; technological changes; changes in consumer spending and saving habits; and the success of the Group in managing the risks involved in the foregoing.

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

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

Operating and financial review

Description of business

Introduction

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

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

Organisational structure and business overview

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Competition

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

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

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

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

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

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

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

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

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

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

Operating and financial review continued

Risk factors

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

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

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

Changes in interest rates, foreign exchange rates, equity prices and other market factors affect the Group's business

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

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

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

Operational risks are inherent in the Group's business

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

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

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

Future growth in the Group's earnings and shareholder value depends on strategic decisions regarding organic growth and potential acquisitions

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

Critical accounting policies

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

The judgements and assumptions involved in the 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.

Provisions for bad and doubtful debts

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

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

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

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

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

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

Loans and advances – recognition of interest income

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

Pensions

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

Fair value

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

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

Operating and financial review continued

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

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

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

General insurance claims

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

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

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

Goodwill

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

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

Accounting developments

UK GAAP

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

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

International Financial Reporting Standards

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

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

Goodwill [IFRS require goodwill arising on the acquisition of subsidiaries or associates to be capitalised. Amortisation of goodwill is prohibited but it must be tested annually for impairment (and whenever changes in circumstances indicate impairment). Under the Group's UK GAAP accounting policy, goodwill arising on acquisitions

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

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

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

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

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

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

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

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

Operating and financial review continued

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

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

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

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

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

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

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

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

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

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

In the opening balance sheet the entity:

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

IFRS 1 provides certain optional exemptions from the above principles:

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

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

January 2005.

IFRS 1 prohibits retrospective application of some aspects of IFRS:

- Derecognition of financial assets and financial liabilities – the derecognition requirements of IAS 39 are to be applied prospectively for transactions occurring on or after 1 January 2004. However, an entity is permitted to apply the derecognition requirements retrospectively from a date of its choice.
- Hedge accounting – at the transition date, all derivatives must be measured at fair value. Gains and losses deferred under previous accounting must be eliminated. Hedge accounting for relationships that do not qualify under IAS 39 must be discontinued in accordance with the hedge termination rules in IAS 39.
- Assets classified as held for sale and discontinued operations – entities with a transition date before 1 January 2005 must apply the transition rules in IFRS 5 – Non-current Assets Held for Sale and Discontinued Operations.

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

US GAAP

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

Operating and financial review continued

Financial highlights

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

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

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

Notes:

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

* restated (see page 85)

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

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

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

* restated (see page 85)

** Integration costs included in operating expenses comprise:

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

Operating and financial review continued

2004 compared with 2003

Profit

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

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

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

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

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

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

Total income

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

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

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

Net interest margin

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

Operating expenses

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

Cost:income ratio

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

Net insurance claims

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

Provisions

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

Credit quality

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

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

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

Earnings and dividends

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

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

Balance sheet

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

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

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

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

Profitability

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

2003 compared with 2002

Profit

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

Total income

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

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

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

Net interest margin

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

Operating expenses

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

Cost:income ratio

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

Net insurance claims

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

Provisions

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

Credit quality

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

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

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

Operating and financial review continued

Earnings and dividends

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

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

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

Balance sheet

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

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

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

Profitability

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

Acquisitions

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

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

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

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

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

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

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

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

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

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

Disposals

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

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Analysis of results

| | 2004 £m | 2003 £m | 2002 £m |
|--|------------|------------|------------|
| Net interest income | | | |
| Interest receivable | 16,696 | 13,998 | 13,561 |
| Interest payable | (7,488) | (5,697) | (5,712) |
| Net interest income | 9,208 | 8,301 | 7,849 |
| | % | % | % |
| Gross yield on interest-earning assets of the banking business | 5.30 | 5.00 | 5.41 |
| Cost of interest-bearing liabilities of the banking business | (2.70) | (2.32) | (2.70) |
| Interest spread of the banking business | 2.60 | 2.68 | 2.71 |
| Benefit from interest-free funds | 0.32 | 0.29 | 0.42 |
| Net interest margin of the banking business | 2.92 | 2.97 | 3.13 |
| Yields, spreads and margins of the banking business | % | % | % |
| Gross yield | | | |
| Group | 5.30 | 5.00 | 5.41 |
| UK | 5.70 | 5.20 | 5.56 |
| Overseas | 4.38 | 4.44 | 4.97 |
| Interest spread | | | |
| Group | 2.60 | 2.68 | 2.71 |
| UK | 2.68 | 2.68 | 2.72 |
| Overseas | 2.48 | 2.71 | 2.69 |
| Net interest margin | | | |
| Group | 2.92 | 2.97 | 3.13 |
| UK | 2.96 | 2.95 | 3.14 |
| Overseas | 2.83 | 3.02 | 3.09 |
| The Royal Bank of Scotland plc base rate | 4.38 | 3.69 | 4.00 |
| London inter-bank three month offered rates: | | | |
| Sterling | 4.64 | 3.74 | 4.06 |
| Eurodollar | 1.62 | 1.22 | 1.80 |
| Euro | 2.11 | 2.33 | 3.32 |

Notes:

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

2004 compared with 2003

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

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

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

2003 compared with 2002

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

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

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

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

Operating and financial review continued

Average balance sheet and related interest

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

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

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

* restated (see page 85)

Notes:

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

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

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

* restated (see page 85)

Notes:

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

Analysis of change in net interest income □ volume and rate analysis

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

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

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

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

Note:

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

2004 compared with 2003

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

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

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

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

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

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

2003 compared with 2002

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

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

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

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

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

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

Operating and financial review continued**Operating expenses***

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

* includes integration costs (see page 23)

** restated (see page 85)

2004 compared with 2003

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

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

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

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

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

2003 compared with 2002

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

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

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

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

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

Integration costs (included in operating expenses)

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

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

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

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

Accruals in relation to integration costs are set out below.

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

Operating and financial review continued**Provisions**

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

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

2004 compared with 2003

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

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

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

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

2003 compared with 2002

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

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

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

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

Taxation

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

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

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

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

* restated (see page 85)

Divisional performance

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

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

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

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

** restated following the implementation of FRS 17

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

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Operating and financial review continued

Corporate Banking and Financial Markets

| | 2004 £m | 2003 £m | 2002 £m |
|---|--------------|--------------|--------------|
| Net interest income excluding funding cost of rental assets | 2,959 | 2,653 | 2,631 |
| Funding cost of rental assets | (414) | (329) | (282) |
| Net interest income | 2,545 | 2,324 | 2,349 |
| Fees and commissions receivable | 1,723 | 1,537 | 1,394 |
| Fees and commissions payable | (277) | (220) | (157) |
| Dealing profits (before associated direct costs) | 1,855 | 1,661 | 1,338 |
| Income on rental assets | 1,282 | 1,088 | 931 |
| Other operating income | 381 | 307 | 197 |
| Non-interest income | 4,964 | 4,373 | 3,703 |
| Total income | 7,509 | 6,697 | 6,052 |
| Direct expenses | | | |
| □ staff costs | 1,642 | 1,410 | 1,230 |
| □ other | 412 | 394 | 375 |
| □ operating lease depreciation | 610 | 518 | 461 |
| | 2,664 | 2,322 | 2,066 |
| Contribution before provisions | 4,845 | 4,375 | 3,986 |
| Provisions | 580 | 755 | 725 |
| Contribution | 4,265 | 3,620 | 3,261 |
| | £bn | £bn | £bn |
| Total assets* | 265.3 | 219.0 | 203.4 |

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

*excluding repos and reverse repos

2004 compared with 2003

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

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

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

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

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

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

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

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

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

2003 compared with 2002

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

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

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

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

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

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

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

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

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

Operating and financial review continued

Retail Banking

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

| | | | |
|---|-------|-------|-------|
| Total income | 4,742 | 4,473 | 4,279 |
| Direct expenses | | | |
| □ staff costs | 834 | 793 | 729 |
| □ other | 240 | 237 | 263 |
| | 1,074 | 1,030 | 992 |
| Contribution before provisions | 3,668 | 3,443 | 3,287 |
| Provisions | 389 | 273 | 213 |
| Contribution | 3,279 | 3,170 | 3,074 |
| | £bn | £bn | £bn |
| Total banking assets | 74.2 | 63.9 | 57.4 |
| Loans and advances to customers □ gross | | | |
| □ mortgages | 44.1 | 36.6 | 32.1 |
| □ small business | 15.2 | 13.8 | 12.5 |
| □ consumer lending | 12.9 | 11.4 | 11.0 |
| Customer deposits | 70.6 | 66.5 | 61.9 |
| Weighted risk assets | 49.7 | 42.9 | 38.8 |

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

2004 compared with 2003

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

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

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

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

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

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

2003 compared with 2002

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

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

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

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

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

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

Operating and financial review continued

Retail Direct

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

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| | | | |
|---|--------------|------------|------------|
| □ other | 453 | 446 | 411 |
| | 712 | 657 | 601 |
| Contribution before provisions | 1,417 | 1,178 | 989 |
| Provisions | 377 | 297 | 281 |
| Contribution | 1,040 | 881 | 708 |
| | £bn | £bn | £bn |
| Total assets | 26.9 | 21.9 | 19.4 |
| Loans and advances to customers □ gross | | | |
| □ mortgages | 9.2 | 8.2 | 7.0 |
| □ other | 16.0 | 13.8 | 12.4 |
| Customer deposits | 4.4 | 4.4 | 4.4 |
| Weighted risk assets | 21.1 | 16.8 | 14.4 |

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

2004 compared with 2003

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

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

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

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

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

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

2003 compared with 2002

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

Total income was up 15% or £245 million to £1,835 million, reflecting continued strong growth in supermarket banking (TPF), mortgages and cards. Net interest income was up 13% or £100 million to £849 million. Average

lending rose by 15% to £20.3 billion of which average mortgage lending was 20% higher at £7.6 billion mainly in The One account. Average customer deposits were up 5% to £4.4 billion. During 2003, the total number of customer accounts increased by 1.7 million.

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

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

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

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Manufacturing

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

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

2004 compared with 2003

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

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

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

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

2003 compared with 2002

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

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

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

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

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Operating and financial review continued

Wealth Management

| | 2004 £m | 2003* £m | 2002* £m |
|--|------------|-------------|-------------|
| Net interest income | 497 | 457 | 451 |
| Non-interest income | 451 | 352 | 370 |
| Total income | 948 | 809 | 821 |
| Expenses | | | |
| □ staff costs | 299 | 259 | 279 |
| □ other | 164 | 139 | 146 |
| | 463 | 398 | 425 |
| Contribution before provisions | 485 | 411 | 396 |
| Provisions for bad and doubtful debts □ charge/(release) | 17 | 9 | (11) |
| Contribution | 468 | 402 | 407 |
| | £bn | £bn | £bn |
| Loans to customers | 9.2 | 7.9 | 7.3 |
| Investment management assets □ excluding deposits | 22.3 | 22.3 | 16.1 |
| Customer deposits | 31.7 | 29.1 | 28.9 |
| Weighted risk assets | 8.3 | 9.1 | 8.4 |

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

2004 compared with 2003

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

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

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

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

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

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

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

2003 compared with 2002

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

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

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

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

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

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

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

RBS Insurance

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

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| | | | |
|---|--------------|--------------|--------------|
| Earned premiums | 5,357 | 3,627 | 2,442 |
| Reinsurers' share | (413) | (504) | (489) |
| Insurance premium income | 4,944 | 3,123 | 1,953 |
| Net fees and commissions | (488) | (161) | 6 |
| Other income | 478 | 283 | 180 |
| Total income | 4,934 | 3,245 | 2,139 |
| Expenses | | | |
| staff costs | 293 | 222 | 166 |
| other | 299 | 219 | 167 |
| | 592 | 441 | 333 |
| Gross claims | 3,724 | 2,644 | 1,693 |
| Reinsurers' share | (244) | (449) | (343) |
| Net claims | 3,480 | 2,195 | 1,350 |
| Contribution | 862 | 609 | 456 |
| In-force policies (000's) | | | |
| Motor: UK | 8,338 | 8,086 | 4,668 |
| Motor: Continental Europe | 1,639 | 1,425 | 1,165 |
| Other (including home, rescue, pet): UK | 10,919 | 10,518 | 6,697 |
| Gross insurance reserves total (£m) | 7,394 | 6,582 | 3,002 |

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

2004 compared with 2003

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

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

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

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

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

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

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

2003 compared with 2002

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

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

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

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

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

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

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

Operating and financial review continued

Ulster Bank

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

| | | | |
|---|-------|-------|-------|
| Total income | 743 | 581 | 520 |
| <hr/> | | | |
| Expenses | | | |
| □ staff costs | 158 | 137 | 122 |
| □ other | 77 | 58 | 58 |
| <hr/> | | | |
| | 235 | 195 | 180 |
| <hr/> | | | |
| Contribution before provisions | 508 | 386 | 340 |
| Provisions | 40 | 32 | 22 |
| <hr/> | | | |
| Contribution | 468 | 354 | 318 |
| <hr/> | | | |
| | £bn | £bn | £bn |
| <hr/> | | | |
| Total assets | 27.4 | 15.6 | 12.7 |
| Loans and advances to customers □ gross | | | |
| □ mortgages | 8.8 | 2.8 | 1.8 |
| □ other | 12.9 | 8.8 | 7.3 |
| Customer deposits | 13.5 | 9.7 | 8.8 |
| Weighted risk assets | 18.5 | 11.0 | 9.0 |
| <hr/> | | | |
| Average exchange rate $\text{€}/\text{£}$ | 1.474 | 1.445 | 1.591 |
| Spot exchange rate $\text{€}/\text{£}$ | 1.418 | 1.416 | 1.536 |
| <hr/> | | | |

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

2004 compared with 2003

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

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

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

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

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

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

2003 compared with 2002

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

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

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

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

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

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

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Citizens

| | 2004 £m | 2003 £m | 2002 £m |
|---|--------------|--------------|--------------|
| Net interest income | 1,540 | 1,310 | 1,248 |
| Non-interest income | 601 | 514 | 468 |
| Total income | 2,141 | 1,824 | 1,716 |
| Expenses | | | |
| □ staff costs | 551 | 505 | 485 |
| □ other | 473 | 374 | 370 |
| | 1,024 | 879 | 855 |
| Contribution before provisions | 1,117 | 945 | 861 |
| Provisions | 80 | 88 | 95 |
| Contribution | 1,037 | 857 | 766 |
| | \$bn | \$bn | \$bn |
| Total assets | 132.1 | 76.8 | 61.1 |
| Loans and advances to customers □ gross | 83.4 | 43.5 | 31.4 |

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

2004 compared with 2003

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

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

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

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

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

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

2003 compared with 2002

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

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

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

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

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

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

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

Operating and financial review continued

Central items

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

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

2004 compared with 2003

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

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

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

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

2003 compared with 2002

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

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

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

Employee numbers at 31 December

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

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

2004 compared with 2003

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

2003 compared with 2002

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

Operating and financial review continued**Consolidated balance sheet
at 31 December 2004**

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

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

* restated (see page 85)

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Overview of consolidated balance sheet

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Operating and financial review continued

Cash flow

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

2004

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

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

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

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

2003

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

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

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

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

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

2002

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

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

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

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

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

UK GAAP compared with US GAAP

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

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

- A reduction of £437 million relating to derivatives and hedging. Under US GAAP, non-derivative financial instruments cannot be designated as hedges of the foreign exchange exposure of available-for-sale securities; such hedging is permitted under UK GAAP. Under US GAAP, the Group has not designated any of its non-trading derivatives as hedges and these are recorded at fair value. Furthermore, US GAAP requires certain embedded derivatives to be accounted for separately from the host instrument.
- Higher pension costs under US GAAP compared with UK GAAP principally reflecting deferral of actuarial gains and losses over the average remaining service lives of current employees under US GAAP. Actuarial gains and losses are recognised in full in the statement of total recognised gains and losses for the period under UK GAAP.
- A net decrease in net income of £261 million relating to capitalisation and amortisation of software development costs that meet certain criteria under US GAAP. Such costs are generally charged to the profit and loss account under UK GAAP.

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

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

Capital resources

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

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

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

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

Operating and financial review continued

Risk management

Framework

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

- *Group Audit Committee* is a non-executive committee that supports the Board in carrying out its responsibilities for financial reporting including accounting policies, and in respect of internal control and risk assessment. The Group Audit Committee monitors the ongoing process of the identification, evaluation and management of all significant risks throughout the Group. The Committee is supported by Group Internal Audit which provides an independent assessment of the adequacy and effectiveness of the Group's internal controls.
- *Advances Committee* is an executive committee that deals with all transactions that exceed the Group Credit Committee's delegated authority, which in turn approves facility limits in excess of the authorities

delegated to divisional credit committees.

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

- *Group Risk Committee* (["GRC"]), which recommends and approves limits, processes and policies in respect of the effective management of all material risks across the Group.
- *Group Asset and Liability Management Committee* (["GALCO"]), which is responsible for reviewing the balance sheet, funding and capital implications of the Group's strategy and operations. In addition, GALCO monitors and reviews legal, regulatory and accounting developments affecting balance sheet risks and capital. It also reviews the effect of external, economic and environmental changes on the Group's balance sheet, risks, margins and capital.
- *Group Risk Management* (["GRM"]) reports to the GEMC through the Group Finance Director and is responsible for risk policy, measurement and controls across the Group. An assessment of the adequacy and effectiveness of each divisional risk management team is undertaken by GRM on a continuous basis to ensure effective control of risks. Each divisional risk function has a direct reporting line to the Director of Group Risk Management, which reinforces these controls and ensures independence of risk management within each division.
- *Group Treasury* (["GT"]) also reports to the GEMC through the Group Finance Director, and is responsible for the management of the Group's balance sheet, capital raising, liquidity and hedging policies. GT assesses and monitors the effectiveness of the divisional asset and liability management teams.

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

The principal risks that the Group manages are as follows:

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

These risks are discussed on pages 43 to 58.

Credit risk

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

The credit risk framework

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

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

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

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

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

Operating and financial review continued

Credit risk (continued)

Risk asset quality

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

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

Asset quality

S&P equivalent

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

Loans and advances

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

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

Industry analysis

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

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

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

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

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

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

Operating and financial review continued

Credit risk (continued)

Geographic analysis

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

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

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

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Notes:

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

Cross border exposures

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

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

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

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

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

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Risk elements in lending and potential problem loans

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

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

Notes:

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

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

- (2) The Group's UK banking subsidiary undertakings account for loans on a non-accrual basis from the point in time at which the collectability of interest is in significant doubt. Certain subsidiary undertakings of the Group, principally Citizens, generally account for loans on a non-accrual basis when interest or principal is past due 90 days.
- (3) Overdrafts generally have no fixed repayment schedule and consequently are not included in this category.
- (4) Loans which are current as to the payment of principal and interest but in respect of which management have serious doubts about the ability of the borrowers to comply with contractual repayment terms. Substantial security is held in respect of these loans and appropriate provisions are made in accordance with the Group's provisioning policy for bad and doubtful debts.

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

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

Provisions

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

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

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

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

Operating and financial review continued

Credit risk (continued)

Specific and general provisions

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

- *Specific provisions:* arise when the creditworthiness of a borrower has undergone a significant deterioration and the recovery of the advance is in significant doubt. The amount of specific provision reflects the financial condition of the borrower, the realisable value of security and the costs of recovery.
- *General provisions:* cover losses that have not yet been specifically identified but are known from experience to be present in any portfolio of loans. The level of general provision reflects the size and

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diversity of the Group's loan portfolio, past experience, the current state of the economies in which the Group operates and the scope of specific provisioning procedures.

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

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

| Summary of provisions | 2004 £m | 2003 £m | 2002 £m |
|--|----------------|----------------|----------------|
| Specific provision ¹ | 3,648 | 3,356 | 3,323 |
| General provision | 574 | 566 | 597 |
| Total bad and doubtful debt provisions | 4,222 | 3,922 | 3,920 |
| Total loans and advances to customers | 349,691 | 256,453 | 227,244 |
| Specific provision as a percentage of loans and advances to customers | 1.04% | 1.31% | 1.46% |
| General provision as a percentage of loans and advances to customers | 0.17% | 0.22% | 0.26% |
| Total provisions as a percentage of loans and advances to customers | 1.21% | 1.53% | 1.72% |
| Closing provisions for bad and doubtful debts expressed as a: | | | |
| % of REIL | 76% | 76% | 80% |
| % of REIL and PPL | 73% | 68% | 65% |

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

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

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

Analysis of specific provisions

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

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

Notes:

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

Amounts written off and recovered

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

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

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

Notes:

(1) Excludes amounts written off in respect of banks of nil (2003 £ nil; 2002 £1 million).

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

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

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

Notes:

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

Operating and financial review continued

Liquidity risk

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

The management of liquidity risk within the Group is undertaken within limits and other policy parameters set by GALCO, who review monthly and receive, on an exception basis, reports detailing compliance with those policy

parameters. A weekly report is also provided to the GEMC. Compliance is monitored and co-ordinated daily under the stewardship of the Group Treasury function, both in respect of internal policy and the regulatory requirements of the FSA. Detailed liquidity position reports are compiled each day by Group Treasury and reviewed daily and weekly with Financial Markets, who manage day-to-day and intra-day market execution within the policy parameters set.

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

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

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

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

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

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

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

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

Sources of funding

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

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

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

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

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

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

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

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

Operating and financial review continued

Liquidity risk (continued)

Customer lending and customer accounts

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

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

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

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

Sterling liquidity

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

1. a stock of qualifying high quality liquid assets (primarily UK and EU government securities, treasury bills, and cash held in branches) and
2. the sum of:
 - sterling wholesale net outflows contractually due within 5 working days (offset up to a limit of 50%, by 85% of sterling certificates of deposit held which mature beyond five working days); and
 - 5% of retail deposits with a residual contractual maturity of five working days or less.

The Group has exceeded the minimum ratio requirement throughout 2004.

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

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

Liquidity in non-sterling currencies

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

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

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

facilities offered by the Group in the event of either counterparty specific difficulties or a significant widening of interest spreads generally in the commercial paper market.

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

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

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

Operating and financial review continued

Market risk

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

Value-at-risk

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

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

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

Trading

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

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

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

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Non-trading

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

Interest rate risk

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

Treasury

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

(2003 □ £8.3 million).

Retail and corporate banking

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

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

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

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

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Operating and financial review continued

Market risk (continued)

Non-trading (continued)

Non-trading interest rate VaR

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

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

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

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

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

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

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

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

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

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

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

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

Equity risk

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

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

Insurance risk

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

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

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

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

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

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

Enterprise risk

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

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

- People – risks arising from an inappropriate level of staff/inadequately skilled or managed people.
- Process – risk caused by inadequate or failed internal processes.
- Systems – risks of inadequately designed or maintained systems.
- Assets – risk of damage, misappropriation or theft of the Group's physical, logical and intangible assets.

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

- Business – risks arising from product performance/competitor activity, supplier unreliability or customer activity.
- Political – risks caused by political unrest or uncertainty/activity by public interest groups or extremists, and non-compliance with, or changes to, current legislation.
- Environment – risks arising due to demographic, macroeconomic, technical, cultural or environmental change.

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

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

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

Governance

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Board of directors and secretary

Chairman

Sir George Mathewson (age 64)

CBE, DUniv, LLD, FRSE, FCIBS

C (Chairman), N (Chairman)

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

Vice-chairmen

Lord Vallance of Tummel (age 61)

FCIBS

C

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

Sir Angus Grossart (age 67)

CBE, DBA, LLD, FRSE, DL, FCIBS, D.Litt

C

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

Executive directors

Sir Fred Goodwin (age 46)

DUniv, FCIBS, FCIB, LLD

Group Chief Executive

C

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

Lawrence Fish (age 60)

Chairman, President and Chief Executive Officer of Citizens Financial Group, Inc.

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

Gordon Pell (age 54)

FCIBS, FCIB

Chairman, Retail Banking and Wealth Management

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

Fred Watt (age 44)

FCIBS

C

Group Finance Director

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

Non-executive directors

Colin Buchan* (age 50)

A (Acting Chairman), R

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

Jim Currie* (age 63)

D.Litt

R

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

Archie Hunter* (age 61)

A (Chairman Designate)

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

Charles "Bud" Koch (age 58)

Appointed to the Board in September 2004, Bud Koch is an American national. He has extensive professional experience in the USA and is currently chairman of the board of the Federal Home Loan Bank of Cincinnati, chairman of the board of John Carroll University and a trustee of Case Western Reserve University. He was the

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chairman, president and chief executive officer of Charter One Financial, Inc. and its wholly owned subsidiary, Charter One Bank, N.A between 1973 and 2004.

Joe MacHale* (age 53)

A

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

Eileen Mackay* (age 61)

CB, FCIBS

A, R

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

Iain Robertson (age 59)

CBE, FCIBS

Chairman, Corporate Banking and Financial Markets

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

Sir Steve Robson* (age 61)

A

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

Bob Scott* (age 63)

CBE, FCIBS

C, N, R (Chairman)

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

Peter Sutherland* (age 58)

KCMG

N

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

Group Secretary and General Counsel

Miller McLean (age 55)

FCIBS

C

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

A member of the Audit Committee

C member of the Chairman's Advisory Group

N member of the Nominations Committee

R member of the Remuneration Committee

* independent non-executive director

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Report of the directors

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

Profit and dividends

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

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

Activities and business review

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

Business developments

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

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

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

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

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

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

Going concern

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

Ordinary share capital

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

- (a) 165 million ordinary shares placed at an issue price of £16.20 per share;
- (b) 12.9 million ordinary shares allotted as a result of the exercise of options under the company's executive, sharesave and option 2000 schemes and a further 5.6 million ordinary shares allotted in respect of the exercise of options under the NatWest executive and sharesave schemes which had been exchanged for options over the company's shares following the acquisition of NatWest in 2000;
- (c) 23.4 million ordinary shares allotted in lieu of cash dividends; and
- (d) 2.4 million ordinary shares allotted under the company's employee share ownership plan.

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

Preference share capital

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

Trust preferred securities

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

Subordinated liabilities

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

Shareholdings

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

| | Number of shares | % held | | Number of shares | % held |
|--|---------------------|--------|-------------------------------------|---------------------|--------|
| Ordinary shares: | | | 5 ½% cumulative preference shares: | | |
| | | | Commercial Union Assurance plc | 91,429 | 22.86 |
| Cater Allen International | 107,628,711 | 3.42 | Mr P. S. and Mrs J. Allen | 86,999 | 21.75 |
| Legal & General Group plc | 98,761,695 | 3.40 | Bassett-Patrick Securities Limited* | 46,255 | 11.56 |
| Barclays PLC | 93,254,320 | 3.14 | E M Behrens Charitable Trust | 20,000 | 5.00 |
| The Capital Group of Companies, Inc | 95,578,555 | 3.01 | Mrs Gina Wild | 19,800 | 4.95 |
| 11% cumulative preference shares: | | | Trustees of The Stephen Cockburn | | |
| Guardian Royal Exchange Assurance plc | 129,830 | 25.97 | Limited Pension Scheme | 19,879 | 4.97 |
| Windsor Life Assurance Company Limited | 51,510 | 10.30 | Miss Elizabeth Hill | 16,124 | 4.03 |
| Mr S. J. and Mrs J. A. Cockburn | 30,810 | 6.16 | Mr W. T. Hardison Jr. | 13,532 | 3.38 |
| Cleaning Tokens Limited | 25,500 | 5.10 | Ms C. L. Allen | 13,200 | 3.30 |
| | | | Ms J. C. Allen | 12,750 | 3.18 |

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

Directors

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

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

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

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

Directors' interests

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

Employee proposition

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

Employee recruitment

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

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

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

Report of the directors continued

Employee reward

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

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

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

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

Employee learning and development

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

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

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

Employee communication

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

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

Employee consultation

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

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

Diversity

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

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

Health, safety, well being and security

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

Corporate responsibility

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

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

Code of ethics

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

Charitable contributions

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

Corporate governance

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

Political donations

No political donations were made during the year.

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

Policy and practice on payment of creditors

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

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

Auditors

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

By order of the Board.

Miller McLean
Secretary
23 February 2005

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

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Corporate governance

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

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

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

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

Board of directors

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

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

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

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

Board balance and independence

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

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

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

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

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

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

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

Re-election of directors

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

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

Information, induction and professional development

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

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

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

Performance evaluation

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

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

Board Committees

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

Audit Committee

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

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

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

The Audit Committee has a policy on the engagement of the external auditors to supply audit and non-audit services, which takes into account relevant legislation regarding the provision of such services by an external audit

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

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

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

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

Corporate governance continued

Remuneration Committee

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

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

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

Nominations Committee

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

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

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

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

Meetings

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

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

| | | | | |
|---------------|----|--------------------------|--------------------------|--------------------------|
| Mr Sutherland | 10 | <input type="checkbox"/> | <input type="checkbox"/> | 1 |
| Mr Watt | 10 | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |

* Mr Hunter and Mr MacHale were appointed to the Board and the Audit Committee on 1 September 2004. Mr Koch was appointed to the Board on 29 September 2004.

** Mr McLuskie retired from the Board on 23 August 2004.

*** Mr Botin and Mr Inciarte resigned from the Board on 12 November 2004, the effective date of the acquisition of Abbey National plc by Banco Santander Central Hispano SA. They did not attend any Board meetings from June 2004 during the relevant public offer period.

Relations with shareholders

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

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

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

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

Internal control

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

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

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

Disclosure controls and procedures

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

Changes in internal controls

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

Directors' remuneration report

The Remuneration Committee

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

Bob Scott (Chairman)
Colin Buchan
Jim Currie
Eileen Mackay

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

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

Remuneration policy

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

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

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

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

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

Components of executive remuneration

UK based directors

Salary

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

Benefits

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

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

Short-term annual incentives

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

Long-term incentives

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

Medium-term performance plan

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

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

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

Options

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

All executive share options are subject to a performance target, which is currently that the options are exercisable only if, over a three year period, the growth in the company's EPS has exceeded the growth in the RPI plus nine per cent. This EPS performance target, which is consistent with market practice, measures underlying financial performance and represents a long-term test of performance. For awards made in 2004 onwards, there is no

re-testing of the performance condition. The condition is reviewed annually. All previous awards have vested without re-testing.

Directors' remuneration report continued

US based director □ *Lawrence Fish*

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

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

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

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

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

Long term incentives will consist of the following components:

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

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

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

The performance graph

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

Total shareholder return

Service contracts

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

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

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

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

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

* retired 23 August 2004

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

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

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

- If Lawrence Fish's contract is terminated without cause, or if he terminates the contract for good reason (as defined in the contract), he is entitled to a lump sum payment to compensate him for the loss of 12 months salary plus annual bonus. Mr Fish would also be entitled to receive for this period health, life insurance and long term disability coverage and any other benefits determined in accordance with the plans, policies and

practices of Citizens at the time of termination. The Remuneration Committee have been advised that these termination provisions are less generous than the current market practice in the US.

Chairman and non-executive directors

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

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

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

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

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

Directors' remuneration report continued*Directors' remuneration*

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

* includes 10% profit sharing

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

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

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

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

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

Share options

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

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

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

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

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

Directors' remuneration report continued

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

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

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

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

Medium Term Performance Plan

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

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

* Awards were granted on 11 April 2002 and vested at 76.29% at the end of the performance period on 31 December 2004.

** The exercise and vesting of awards in 2004 for Mr McLuskie occurred after his retirement from the Board on 23 August 2004.

Note:

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

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

Phantom 2000 Plan

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

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

Citizens Long Term Incentive Plan

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

* Under the cash LTIP, target payment is 60% of average salary over the three year period, maximum payment is 105% of average salary. No variation was made to any of the terms of the plan during the year. The performance measures are detailed on page 72.

Directors' pension arrangements

During the year, Sir Fred Goodwin, Norman McLuskie, Gordon Pell, Iain Robertson and Fred Watt participated in The Royal Bank of Scotland Group Pension Fund (the RBS Fund). The RBS Fund is a defined benefit fund which provides pensions and other benefits within Inland Revenue limits.

The pension entitlements of Sir Fred Goodwin, Mr Pell, Mr Robertson, and Mr Watt within the RBS Fund are restricted by Inland Revenue limits as set out in the Finance Act 1989. Additional life assurance cover in excess of these limits is provided by a separate arrangement. Arrangements have been made to provide Sir Fred Goodwin and Mr Pell with additional pension benefits on a defined benefit basis outwith the RBS Fund. The figures shown below include the accrual in respect of these arrangements. Mr Watt is provided with additional pension benefits on a defined contribution basis and contributions made in the year are shown below.

Sir George Mathewson receives life insurance cover under an individual arrangement. The non-executive directors do not accrue pension benefits, other than Mr Robertson who continues to accrue benefits in the RBS Fund after his appointment as a non-executive director.

Lawrence Fish accrues pension benefits under a number of arrangements in the USA. Defined benefits are built up under the Citizens' Qualified Plan, Excess Plan and Supplemental Executive Retirement Arrangement. In addition, he is a member of two defined contribution arrangements - a Qualified 401(k) Plan and an Excess 401(k) Plan.

As in the 2003 Report and Accounts, disclosure of these benefits has been made in accordance with the Stock Exchange Listing Rules and the Combined Code and with the Directors' Remuneration Report Regulations 2002.

| Defined benefit arrangements | Age at 31 December 2004 | Accrued entitlement at 31 December 2004 | Additional pension earned during the year ended 31 December 2004 | Additional pension earned during the year ended 31 December 2004* | Transfer value as at 31 December 2004 | Transfer value as at 31 December 2003 | Increase in transfer value during year ended 31 December 2004 | Transfer value for the additional pension earned during the year ended 31 December 2004* |
|------------------------------|-------------------------|---|--|---|---------------------------------------|---------------------------------------|---|--|
| | | 000 p.a. | 000 p.a. | 000 p.a. | 000 | 000 | 000 | 000 |
| Sir Fred Goodwin | 46 | £ 381 | £ 56 | £ 48 | £ 3,591 | £ 2,674 | £ 917 | £ 448 |
| Mr McLuskie | 60 | £ 205 | £ 11 | £ 7 | £ 3,430 | £ 3,358 | £ 72 | £ 87 |
| Mr Pell | 54 | £ 247 | £ 18 | £ 12 | £ 3,592 | £ 2,930 | £ 662 | £ 171 |
| Mr Robertson | 59 | £ 32 | £ 4 | £ 3 | £ 565 | £ 449 | £ 116 | £ 45 |
| Mr Watt | 44 | £ 7 | £ 2 | £ 2 | £ 62 | £ 40 | £ 22 | £ 15 |
| Mr Fish | 60 | \$ 1,140 | \$ 257 | \$ 257 | \$ 10,046 | \$ 9,966 | \$ 80 | \$ 2,269 |

* net of statutory revaluation applying to deferred pensions

Notes:

- (1) There is a significant difference in the form of disclosure required by the Combined Code and the Directors' Remuneration Report Regulations 2002. The former requires the disclosure of the additional pension earned during the year and the transfer value equivalent to this pension based on stock market conditions at the end of the year. The latter requires the disclosure of the difference between the transfer value at the start and end of the year and is

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therefore dependent on the change in stock market conditions over the course of the year. The above disclosure has been made in accordance with the Combined Code and the Directors' Remuneration Report Regulations 2002.

- (2) Mr McLuskie retired on 23 August 2004 at his normal pension age. The figures for him above have been calculated as at his retirement date rather than 31 December 2004.
- (3) The figures for Mr Pell include an additional pension secured by a transfer from his previous employer which increases in line with statutory revaluation, not salary inflation.
- (4) The transfer values disclosed above do not represent a sum paid or payable to the individual director. Instead they represent a potential liability of the company /pension scheme.
- (5) The transfer value for Mr Fish as at 31 December 2004 is based on a retirement age of 65.

Contributions and allowances paid in the year ended 31 December 2004 under defined contribution arrangements were:

| | 2004 000 | 2003 000 |
|---------|-------------|-------------|
| Mr Watt | £ 128 | £ 109 |
| Mr Fish | \$ 91 | \$ 90 |

Bob Scott, Chairman of the Remuneration Committee
23 February 2005

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Directors' interests in shares

Ordinary shares

The following directors held a beneficial interest in the company's ordinary shares:

| | 31 December 2004 | 1 January 2004 or date of appointment if later | | 31 December 2004 | 1 January 2004 or date of appointment if later |
|------------------|------------------------|---|----------------------|------------------------|---|
| Mr Buchan | 5,000 | 5,000 | Sir George Mathewson | 250,816 | 247,978 |
| Mr Fish | 11,120 | 11,120 | Mr Pell | 582 | 582 |
| Sir Fred Goodwin | 64,960 | 64,718 | Mr Robertson | 129,632 | 125,139 |
| Mr Hunter | 1,500 | 1,500 | Mr Scott | 2,448 | 1,445 |
| Mr Koch | 20,000 | 20,000 | Lord Vallance | 2,500 | 2,500 |
| Mr MacHale | 10,000 | □ | Mr Watt | 58,408 | 7,453 |
| Miss Mackay | 6,341 | 6,140 | | | |

No other director had an interest in the company's ordinary shares during the year.

On both 7 January 2005 and 7 February 2005, seven ordinary shares of 25p each were acquired by Sir Fred Goodwin under the Group's Buy As You Earn share scheme.

Preference shares

Lawrence Fish held 20,000 non-cumulative preference shares of US\$0.01 each at 31 December 2004 (2003 20,000). No other director had an interest in the preference shares during the year.

Loan notes

No director had an interest in loan notes during the year.

The company's Register of Directors' Interests, which is open to inspection, contains full details of directors' shareholdings and options to subscribe.

No director held a non-beneficial interest in the shares of the company at 31 December 2004, at 1 January 2004 or date of appointment if later.

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Statement of directors' responsibilities

United Kingdom company law requires the directors to prepare accounts for each financial year which give a true and fair view of the state of affairs of the company and of the Group as at the end of the financial year and of the profit or loss of the Group for that year. In preparing those accounts, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent; and
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the accounts.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and to enable them to ensure that the accounts comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

By order of the Board.

Miller McLean
Secretary
23 February 2005

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Financial statements

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Report of Independent registered public accounting firm to the members of The Royal Bank of Scotland Group plc

We have audited the financial statements of The Royal Bank of Scotland Group plc ("the company") and its subsidiaries (together "the Group") for the year ended 31 December 2004 which comprise the accounting policies, the profit and loss account, the balance sheets, the cash flow statement, the statement of total recognised gains and losses, the reconciliation of movements in shareholders' funds and the related Notes 1 to 55. These financial

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statements have been prepared under the accounting policies set out therein. We have also audited the information in the part of the directors' remuneration report that is described as having been audited.

Respective responsibilities of directors and auditors

As described in the 'Statement of directors' responsibilities', the company's directors are responsible for the preparation of the financial statements in accordance with applicable United Kingdom law and accounting standards. They are also responsible for the preparation of the other information contained in the 2004 Annual Report on Form 20-F including the directors' remuneration report. Our responsibility is to audit the financial statements and the part of the directors' remuneration report described as having been audited in accordance with relevant United Kingdom legal and regulatory requirements and auditing standards.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the directors' remuneration report described as having been audited have been properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the directors' report is not consistent with the financial statements, if the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and transactions with the company and other members of the Group is not disclosed.

We review whether the corporate governance statement reflects the company's compliance with the nine provisions of the Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the directors' report and the other information contained in the 2004 Annual Report on Form 20-F as described in the contents section including the unaudited part of the directors' remuneration report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements.

Basis of audit opinion

We conducted our audit in accordance with United Kingdom auditing standards issued by the Auditing Practices Board and with the standards of the United States Public Company Accounting Oversight Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the directors' remuneration report described as having been audited. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control over financial reporting. Accordingly, we express no such opinion. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements and of whether the accounting policies are appropriate to the circumstances of the company and the Group, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the directors' remuneration report described as having been audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the directors' remuneration report described as having been audited.

UK opinion

In our opinion the financial statements give a true and fair view of the state of affairs of the company and the Group as at 31 December 2004 and of the profit and cash flows of the Group for the year then ended and the financial statements and the part of the directors' remuneration report described as having been audited have been properly prepared in accordance with the Companies Act 1985.

US opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Group as at 31 December 2004 and 2003 and the results of its operations and its cash flows for each of the three years in the period ended 31 December 2004 in conformity with accounting principles generally accepted in the United Kingdom.

As discussed in Note 1, the Group has adopted Financial Reporting Standard 17 "Retirement Benefits". As required by accounting principles generally accepted in the United Kingdom, the financial position of the Group, the results of its operations and its cash flows for 2003 and 2002 have been restated and are presented on a comparable basis.

Accounting principles generally accepted in the United Kingdom vary in certain significant respects from accounting principles generally accepted in the United States of America. The application of the latter would have affected the determination of net income for each of the three years in the period ended 31 December 2004 and the determination of shareholders' equity as at 31 December 2004 and 2003, to the extent summarised in Note 53 to the financial statements.

Deloitte & Touche LLP
Chartered Accountants and Registered Auditors
Edinburgh
23 February 2005

Accounting policies

The accounts have been prepared in accordance with applicable Accounting Standards in the UK and the Statements of Recommended Accounting Practice issued by the British Bankers' Association and by the Finance and Leasing Association. The Statement of Recommended Practice issued by the Association of British Insurers (2003) has been followed by the insurance members of the Group; they have been consolidated in the recognised manner for banking groups, in particular, by using the embedded value method for life business. A summary of the more important accounting policies is set out below. The consolidated accounts are prepared in accordance with the special provisions of Part VII of the Companies Act 1985 ("the Act") relating to banking groups.

The accounts of the company are prepared in accordance with section 226 of, and Schedule 4 to, the Act and, as permitted by section 230(3) of the Act, no profit and loss account is presented.

Change of accounting policy

FRS 17 "Retirement Benefits" ("FRS 17") supersedes Statement of Standard Accounting Practice 24 'Pension costs' ("SSAP24") and the Urgent Issues Task Force Abstract 6 "Accounting for post-retirement benefits other than pensions". All the disclosure requirements of FRS 17 were adopted by the Group in its 2002 financial statements. In November 2002, the Accounting Standards Board deferred the effective date of the recognition and measurement elements of the standard to accounting periods beginning on or after 1 January 2005. The Group has, however, implemented the recognition and measurement provisions of FRS 17 in 2004 in the light of the introduction of International Financial Reporting Standards from 1 January 2005; the measurement principles in the equivalent international accounting standard (IAS 19 "Employee Benefits") are similar to those in FRS 17.

FRS 17 requires assets in a defined benefit scheme to be measured at their fair value at the balance sheet date. Scheme liabilities are measured using the projected unit method, which takes account of projected earnings

increases, using actuarial assumptions that are mutually compatible and lead to the best estimate of the future cash flows. These cash flows are discounted at the interest rate applicable to high-quality corporate bonds of the same currency and term as the liabilities. The surplus/deficit in a defined benefit scheme is the excess/shortfall of the value of the assets in the scheme over/below the value of the scheme liabilities. A surplus is recognised as an asset to the extent that the employer is able to recover the surplus either through reduced contributions in the future or through refunds from the scheme. A deficit is recognised as a liability to the extent of the employer's legal or constructive obligation to fund it. The current service cost (the increase in scheme liabilities arising from employee service in the current period), past service costs (the cost of improvements to benefits for service relating to prior periods) and interest cost (the unwind of the discount on scheme liabilities) net of the expected return on scheme assets are charged to the profit and loss account. Actuarial gains and losses (changes in surpluses or deficits due to experience gains and losses and to changes in actuarial assumptions) are recognised in full in the statement of total recognised gains and losses for the period. Under SSAP24 for the main defined benefit scheme the profit and loss account charge comprised the cost of accruing benefits for active employees and the amortisation of the surplus recognised on the acquisition of NatWest offset by a credit for the amortisation of the scheme surplus. A pension prepayment was included in the Group's balance sheet.

The effect of this change of policy on the profit and loss account has been to credit £85 million (2003 □ £52 million; 2002 □ £201 million) to Other operating income and to increase Administrative expenses □ staff costs by £217 million (2003 □ £135 million; 2002 □ £112 million). Profit before tax has been reduced by £132 million (2003 □ £83 million; 2002 □ increased by £89 million). A deficit, net of deferred tax, of £1,901 million (2003 □ £1,445 million) has been recognised on the balance sheet; Prepayments and accrued income of £1,079 million (2003 □ £112 million), Other assets of £654 million (2003 □ £735 million) and Accruals and deferred income of £26 million (2003 □ £18 million) have been eliminated; the liability for deferred taxation has reduced by £315 million (2003 □ £230 million) and the Deferred tax asset (within Other assets) has increased by £19 million (2003 □ £20 million). Other provisions have decreased by £73 million (2003 □ £43 million) and shareholders' funds by £3,220 million. A prior year adjustment of £2,001 million is shown in the Statement of consolidated total recognised gains and losses. The prior year adjustment comprises: the recognition of the pension deficit at 31 December 2003 of £1,414 million (£1,968 million less deferred tax of £554 million); the elimination of pension prepayments less accruals of £58 million (net of deferred tax); and the elimination of the pension surplus recognised on the acquisition of NatWest amounting to £529 million (net of deferred tax and amortisation).

1 Accounting convention and bases of consolidation

The accounts are prepared under the historical cost convention modified by the periodic revaluation of premises and certain investments. To avoid undue delay in the presentation of the Group's accounts, the accounts of certain subsidiary undertakings have been made up to 30 November. There have been no changes in respect of these subsidiary undertakings, in the period from their balance sheet dates to 31 December, that materially affect the view given by the Group's accounts.

2 Revenue recognition

Interest is credited to the profit and loss account as it accrues unless there is significant doubt that it can be collected (as described in the accounting policy on loans and advances).

Fees in respect of services are recognised as the right to consideration accrues through performance to customers. Services in respect of financial services related products, the arrangement is generally contractual, the cost of providing this service is incurred as the service is rendered and the price is usually fixed and always determinable. The application of the Group's policy to significant fee types is outlined below.

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Loan origination fees: up-front lending fees are recognised as income when receivable except where they are charged in lieu of interest or charged to cover the cost of a continuing service to the borrower, in which case they are credited to income over the life of the advance.

Commitment and utilisation fees: these are generally determined as a percentage of the outstanding used or unused facility. They are usually charged to the customer in arrears and recognised when charged.

Payment services: this comprises income received for payment services including cheques cashed, direct debits, Clearing House Automated Payments (the UK electronic settlement system) and BACS payments (the automated clearing house that processes direct debits and direct credits). These are generally charged on a per transaction basis. The income is earned when the payment or transaction occurs. Payment services income is usually charged to the customer's account, monthly or quarterly in arrears. Accruals are raised for services provided but not charged at period end.

Card related services: fees from credit card business include:

Commission received from retailers for processing credit and debit card transactions: income is accrued to the profit and loss account as the service is performed.

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

An annual fee payable by a credit card holder is charged at the beginning of each year but is deferred and taken to income over the period of the service i.e. 12 months.

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

Securities and derivatives held for trading are recorded at fair value. Changes in fair value are recognised in dealing profits together with dividends from, and interest receivable and payable on, trading business assets and liabilities.

3 Goodwill

Goodwill is the excess of the cost of acquisition of subsidiary and associated undertakings over the fair value of the Group's share of net tangible assets acquired. Goodwill arising on acquisitions of subsidiary and associated undertakings after 1 October 1998 is capitalised on the balance sheet and amortised on a straight-line basis over its estimated useful economic life, currently over periods up to 20 years. Capitalised goodwill is reviewed for impairment at the end of the first full year following an acquisition and subsequently if events or changes in circumstances indicate that its carrying value may not be recoverable in full. Goodwill arising on acquisitions of subsidiary and associated undertakings prior to 1 October 1998, previously charged directly against profit and loss account reserves, was not reinstated under the transitional provisions of FRS 10 "Goodwill and Intangible Assets". It will be written back only on disposal and reflected in the calculation of the gains or losses arising.

4 Foreign currencies

Monetary assets and liabilities denominated in foreign currencies are translated into sterling at the rates of exchange ruling at the balance sheet date. Profit and loss accounts of overseas branches and subsidiary undertakings are translated at the average rates of exchange for the period. Exchange differences arising from the application of closing rates of exchange to the opening net assets of overseas branches and subsidiary undertakings and from restating their results from average to period-end rates are taken to profit and loss account reserves, together with exchange differences arising on related foreign currency borrowings. All other exchange differences are included in operating profit.

5 Pensions and other post-retirement benefits

The Group provides retirement benefits, in the form of pensions and healthcare plans, to eligible employees. Defined benefit scheme liabilities are measured on an actuarial basis using the projected unit method and discounted at a rate that equals the current rate of return on a high quality corporate bond of equivalent term and currency to the scheme liabilities. Scheme assets are measured at their fair value. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit), net of related notional deferred tax. An asset is only recognised to the extent that the surplus can be recovered through reduced contributions in the future or through refunds from the scheme.

The current service cost and any past service costs are charged to the profit and loss account within Administrative expenses □ staff costs. The expected return on scheme assets less the unwinding of the discount on the scheme liabilities is included in Other operating income. Actuarial gains and losses are recognised in the statement of total recognised gains and losses, net of related notional deferred tax.

6 Leases

Contracts to lease assets and hire purchase agreements are classified as finance leases if they transfer substantially all the risks and rewards of ownership of the asset to the customer. Other contracts are classified as operating leases. Total gross earnings under finance leases are allocated to accounting periods using the actuarial after tax method to give a constant periodic rate of return on the net cash investment. Finance lease receivables are stated in the balance sheet at the amount of the net investment in the lease. Rental income from operating leases is credited to the profit and loss account on a receivable basis over the term of the lease. Balance sheet carrying values of finance lease receivables and operating lease assets include amounts in respect of the residual values of the leased assets. Unguaranteed residual values are subject to regular review to identify potential impairments. Provisions are made for impairment arising on specific asset categories.

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7 General insurance

General insurance comprises short-duration contracts and include principally property and liability insurance contracts. Due to the nature of the products sold □ retail based property and casualty, motor, home and personal health insurance contracts □ the insurance protection is provided on an even basis throughout the term of the policy.

In calculating operating profit from general insurance activities, premiums (net of reinsurance premiums) are recognised in the accounting period in which they begin. Unearned premiums represent the proportion of the net premiums that relate to periods of insurance after the balance sheet date and are calculated over the period of exposure under the policy, on a daily basis, 24th□s basis or allowing for the estimated incidence of exposure under policies which are longer than twelve months. Provision is made where necessary for the estimated amount required over and above unearned premiums net of reinsurance, including that in respect of future written business on discontinued lines under the run-off of delegated underwriting authority arrangements. It is designed to meet future claims and related expenses and is calculated across related classes of business on the basis of a separate carry forward of deferred acquisition expenses after making allowance for investment income.

Acquisition expenses relating to new and renewed business for all classes are deferred over the period during which the premiums are unearned. The principal acquisition costs so deferred are commissions payable, direct advertising expenditure, costs associated with the telesales and underwriting staff and prepaid claims handling costs in respect of delegated claims handling arrangements for claims which are expected to occur after the balance sheet date.

Claims (net of reinsurance) are recognised in the accounting period in which the loss occurs. Provision is made for the full cost (net of reinsurance) of settling outstanding claims at the balance sheet date, including claims estimated to have been incurred but not yet reported at that date, and claims handling expenses.

8 Long-term life assurance business

The Group's long-term assurance business includes whole-life, guaranteed renewable term life, endowment, annuity and universal life contracts that are expected to remain in force for an extended period of time, generally five to forty years.

The value placed on the Group's long-term life assurance business comprises the net assets of the Group's life assurance subsidiaries, including its interest in the surpluses retained within the long-term assurance funds, and the present value of profits inherent in in-force policies. In calculating the value of in-force policies, future surpluses expected to emerge are estimated using appropriate assumptions as to future mortality, persistency and levels of expenses, which are then discounted at a risk-adjusted rate. Changes in this value, which is determined on a post-tax basis, are included in operating profit, grossed up at the underlying rate of taxation. Long-term assurance assets attributable to policyholders are valued on the following bases: equity shares and debt securities at market price; investment properties and loans at valuation. These assets are held in the life funds of the Group's life assurance companies, and although legally owned by them, the Group only benefits from these assets when surpluses are declared. To reflect the distinct nature of the long-term assurance assets, they are shown separately on the consolidated balance sheet, as are liabilities attributable to policyholders.

The Group has reinsured contracts that transfer significant insurance risk. Within net assets, the reinsurance cash flows are recognised when they become payable. For most contracts this effectively spreads the cost of reinsurance over the life of the reinsured contracts. In some cases, the acquisition costs are financed by the reinsurer offering a nil premium payment period. In these cases, the acquisition costs incurred on the underlying insurance contracts are compared with the benefit arising with respect to the nil premium paying period on the reinsurance contract.

9 Loans and advances

The Group makes provisions for bad and doubtful debts, through charges to the profit and loss account, so as to record impaired loans and advances at their expected ultimate net realisable value.

Specific provisions are made against individual loans and advances that the Group no longer expects to recover in full. For the Group's portfolios of smaller balance homogeneous advances, such as credit card receivables, specific provisions are established on a portfolio basis taking into account the level of arrears, security and past loss experience. For loans and advances that are individually assessed, the specific provision is determined from a review of the financial condition of the borrower and any guarantor and takes into account the nature and value of any security held.

The general provision is made to cover bad and doubtful debts that have not been separately identified at the balance sheet date but are known to be present in any portfolio of advances. The level of general provision is determined in the light of past experience, current economic and other factors affecting the business environment and the Group's monitoring and control procedures, including the scope of specific provisioning procedures.

Specific and general provisions are deducted from loans and advances. When there is significant doubt that interest receivable can be collected, it is excluded from the profit and loss account and credited to an interest suspense account. Loans and advances and suspended interest are written off in part or in whole when there is no realistic prospect of recovery.

10 Taxation

Provision is made for taxation at current enacted rates on taxable profits taking into account relief for overseas taxation where appropriate. Timing differences arise where gains and losses are accounted for in different periods for financial reporting purposes and for taxation purposes. Deferred taxation is accounted for in full for all such timing differences, except in relation to revaluations of fixed assets where there is no commitment to dispose of the asset, taxable gains on sales

Accounting policies continued

of fixed assets that are rolled over into the tax cost of replacement assets, and unremitted overseas earnings. Deferred tax assets are only recognised to the extent that it is considered more likely than not that they will be recovered. Deferred tax amounts are not discounted.

11 Debt securities and equity shares

Debt securities and equity shares intended for use on a continuing basis in the Group's activities are classified as investment securities and are stated at cost less provision for any permanent diminution in value. The cost of dated investment securities is adjusted for the amortisation of premiums or discounts over periods to redemption and the amortisation is included in interest receivable. Other debt securities and equity shares are carried at fair value, with changes in fair value recognised in the profit and loss account.

12 Shares in subsidiary undertakings

The company's shares in subsidiary undertakings are stated in the balance sheet of the company at directors' valuation that takes account of the subsidiary undertakings' net asset values.

13 Tangible fixed assets

Freehold and long leasehold properties are revalued on a rolling basis, each property being revalued at least every five years. Other tangible fixed assets are stated at cost less depreciation and provisions for impairment. Costs of adapting premises for the use of the Group are separately identified and depreciated.

Tangible fixed assets are depreciated to their residual value over their estimated useful economic lives on a straight-line basis, as follows:

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

Assets on operating leases are depreciated over their estimated useful lives on a straight-line or reverse-annuity basis. Land has an unlimited life and is not depreciated.

Investment properties are revalued annually to open market value. No depreciation is charged on freehold investment properties, in accordance with the requirements of Statement of Standard Accounting Practice 19 'Accounting for investment properties'. This is a departure from the requirements of the Companies Act 1985 which requires all tangible fixed assets to be depreciated. Investment properties are held not for consumption but for investment and the directors consider that to depreciate them would not give a true and fair view. It is not practicable to assess estimated useful lives for investment properties, and accordingly the effect of not depreciating them cannot be reasonably quantified.

14 Derivatives

The Group enters into derivative transactions including futures, forwards, swaps and options principally in the interest rate, foreign exchange and equity markets. The accounting treatment for these instruments is dependent upon whether they are entered into for trading or non-trading (hedging) purposes.

Trading

Derivatives held for trading purposes are recognised in the accounts at fair value. Gains or losses arising from changes in fair value are included in dealing profits in the consolidated profit and loss account. Fair value is based on quoted market prices. Where representative market prices are not available, the fair value is determined from current market information using appropriate pricing or valuation models. Adjustments are made to quoted market prices where appropriate to cover credit risk, liquidity risk and future operational costs. In the consolidated balance sheet, positive fair values (assets) of trading derivatives are included in Other assets and negative fair values (liabilities) in Other liabilities. Positive and negative fair values of trading derivatives are offset where the contracts have been entered into under master netting agreements or other arrangements that give a legally enforceable right of set-off.

Non-trading

Non-trading derivatives are entered into by the Group to hedge exposures arising from transactions entered into in the normal course of banking activities. They are recognised in the accounts in accordance with the accounting treatment of the underlying transaction or transactions being hedged. To be classified as non-trading, a derivative must match or eliminate the risk inherent in the hedged item from potential movements in interest rates, exchange rates or market values. In addition, there must be a demonstrable link to an underlying transaction, pool of transactions or specified future transaction or transactions. Specified future transactions must be reasonably certain to arise for the derivative to be accounted for as a hedge. In the event that a non-trading derivative transaction is terminated or ceases to be an effective hedge, the derivative is re-measured at fair value and any resulting profit or loss amortised over the remaining life of the underlying transaction or transactions being hedged. If a hedged item is derecognised, or a specified future transaction is no longer likely to occur, the related non-trading derivative is re-measured at fair value and the resulting profit or loss taken to the profit and loss account.

15 Sale and repurchase transactions

Securities which have been sold with an agreement to repurchase continue to be shown on the balance sheet and the sale proceeds recorded as a deposit. Securities acquired in reverse sale and repurchase transactions are not recognised in the balance sheet and the purchase price is treated as a loan. The difference between the sale price and repurchase price is accrued evenly over the life of the transaction and charged or credited to the profit and loss account as interest payable or receivable.

Consolidated profit and loss account

for the year ended 31 December 2004

| | Note | 2004 £m | 2003* £m | 2002* £m |
|---|------|--------------|--------------|--------------|
| Interest receivable | | | | |
| □ interest receivable and similar income arising from debt securities | | 1,517 | 1,519 | 1,591 |
| □ other interest receivable and similar income | | 15,179 | 12,479 | 11,970 |
| Interest payable | | (7,488) | (5,697) | (5,712) |
| Net interest income | | 9,208 | 8,301 | 7,849 |
| Dividend income | | 79 | 58 | 58 |

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| | | | | |
|--|----|---------------|---------------|---------------|
| Fees and commissions receivable | | 6,634 | 5,693 | 5,249 |
| Fees and commissions payable | | (1,954) | (1,337) | (965) |
| Dealing profits | 1 | 1,988 | 1,793 | 1,462 |
| Other operating income | | 1,855 | 1,650 | 1,410 |
| | | 8,602 | 7,857 | 7,214 |
| General insurance | | | | |
| □ earned premiums | | 5,357 | 3,627 | 2,442 |
| □ reinsurance | | (413) | (504) | (489) |
| Non-interest income | | 13,546 | 10,980 | 9,167 |
| Total income | | 22,754 | 19,281 | 17,016 |
| Administrative expenses | | | | |
| □ staff costs** | 2 | 5,344 | 4,653 | 4,584 |
| □ premises and equipment** | | 1,184 | 1,073 | 1,006 |
| □ other** | | 2,296 | 2,108 | 2,253 |
| Depreciation and amortisation | | | | |
| □ tangible fixed assets** | 20 | 1,107 | 919 | 895 |
| □ goodwill | 19 | 915 | 763 | 731 |
| Operating expenses | | 10,846 | 9,516 | 9,469 |
| Profit before other operating charges | | 11,908 | 9,765 | 7,547 |
| General insurance | | | | |
| □ gross claims | | 3,724 | 2,644 | 1,693 |
| □ reinsurance | | (244) | (449) | (343) |
| Profit before provisions for bad and doubtful debts | | 8,428 | 7,570 | 6,197 |
| Provisions for bad and doubtful debts | 13 | 1,428 | 1,461 | 1,286 |
| Amounts written off fixed asset investments | | 83 | 33 | 59 |
| Profit on ordinary activities before tax | 4 | 6,917 | 6,076 | 4,852 |
| Tax on profit on ordinary activities | 5 | 2,155 | 1,888 | 1,582 |
| Profit on ordinary activities after tax | | 4,762 | 4,188 | 3,270 |
| Minority interests (including non-equity) | 32 | 250 | 210 | 133 |
| Profit for the financial year | | 4,512 | 3,978 | 3,137 |
| Preference dividends □ non-equity | 6 | 256 | 261 | 305 |
| | | 4,256 | 3,717 | 2,832 |
| Additional Value Shares dividend □ non-equity | 6 | □□ | 1,463 | 798 |
| Profit attributable to ordinary shareholders | | 4,256 | 2,254 | 2,034 |
| Ordinary dividends | 7 | 1,837 | 1,490 | 1,267 |
| Retained profit | 34 | 2,419 | 764 | 767 |

Per 25p ordinary share:

| | | | | |
|-------------------------|---|--------|-------|-------|
| Basic earnings | 9 | 138.0p | 76.9p | 70.6p |
| Diluted earnings | 9 | 136.9p | 76.3p | 69.6p |
| Dividends | 7 | 58.0p | 50.3p | 43.7p |

All items dealt with in arriving at profit on ordinary activities before tax relate to continuing operations.

Profit on ordinary activities before taxation and the retained profit for the year on a historical cost basis were not materially different from the reported amounts.

* restated (see page 85)

** includes integration expenditure (see Note 4)

Consolidated balance sheet

at 31 December 2004

| | Note | 2004 £m | 2003* £m |
|--|------|----------------|----------------|
| Assets | | | |
| Cash and balances at central banks | | 4,293 | 3,822 |
| Items in the course of collection from other banks | | 2,629 | 2,501 |
| Treasury bills and other eligible bills | 10 | 6,110 | 4,846 |
| Loans and advances to banks | 11 | 58,260 | 51,891 |
| <i>Loans and advances to customers</i> | | <i>350,229</i> | <i>253,392</i> |
| <i>Less: non-returnable finance</i> | 12 | <i>4,760</i> | <i>861</i> |
| | 12 | 345,469 | 252,531 |
| Debt securities | 15 | 91,211 | 79,949 |
| Equity shares | 16 | 2,960 | 2,300 |
| Intangible fixed assets | 19 | 17,576 | 13,131 |
| Tangible fixed assets | 20 | 16,294 | 13,927 |
| Settlement balances | | 5,682 | 2,857 |
| Other assets | 21 | 22,255 | 17,807 |
| Prepayments and accrued income | | 6,928 | 5,309 |
| | | 579,667 | 450,871 |
| Long-term assurance assets attributable to policyholders | 22 | 3,800 | 3,557 |
| Total assets | | 583,467 | 454,428 |

| | | | |
|---|----|----------------|----------------|
| Liabilities | | | |
| Deposits by banks | 23 | 99,081 | 67,323 |
| Items in the course of transmission to other banks | | 802 | 958 |
| Customer accounts | 24 | 285,062 | 236,963 |
| Debt securities in issue | 25 | 58,960 | 41,016 |
| Settlement balances and short positions | 26 | 32,990 | 21,369 |
| Other liabilities | 27 | 26,152 | 20,584 |
| Accruals and deferred income | | 15,588 | 13,155 |
| Post-retirement benefit liabilities | 3 | 1,901 | 1,445 |
| Provisions for liabilities and charges | | | |
| □ deferred taxation | 28 | 2,873 | 2,036 |
| □ other provisions | 29 | 198 | 213 |
| Subordinated liabilities | | | |
| □ dated loan capital | 30 | 11,013 | 9,312 |
| □ undated loan capital including convertible debt | 31 | 9,353 | 7,686 |
| Minority interests | | | |
| □ equity | | 158 | (11) |
| □ non-equity | 32 | 3,671 | 2,724 |
| Called up share capital | 33 | 822 | 769 |
| Share premium account | 34 | 12,964 | 8,175 |
| Merger reserve | 34 | 10,307 | 10,881 |
| Other reserves | 34 | 457 | 419 |
| Revaluation reserve | 34 | 92 | 7 |
| Profit and loss account | 34 | 7,223 | 5,847 |
| <hr/> | | | |
| <i>Shareholders' funds</i> | | | |
| □ equity | | 27,345 | 23,175 |
| □ non-equity | 34 | 4,520 | 2,923 |
| <hr/> | | | |
| Long-term assurance liabilities attributable to policyholders | 22 | 579,667 | 450,871 |
| | | 3,800 | 3,557 |
| <hr/> | | | |
| Total liabilities | | 583,467 | 454,428 |
| <hr/> | | | |
| Memorandum items | | | |
| Contingent liabilities | 41 | 16,093 | 14,864 |
| Commitments (standby facilities, credit lines and other) | 41 | 180,777 | 139,693 |

* restated (see page 85)

The accounts were approved by the Board of directors on 23 February 2005 and signed on its behalf by:

Sir George Mathewson
Chairman

Sir Fred Goodwin
Group Chief Executive

Fred Watt
Group Finance Director

Statement of consolidated total recognised gains and losses

for the year ended 31 December 2004

| | 2004 £m | 2003* £m | 2002* £m |
|--|--------------|--------------|-------------|
| Profit attributable to ordinary shareholders | 4,256 | 2,254 | 2,034 |
| <i>Actuarial (losses)/gains</i> | (1,598) | 69 | (2,392) |
| <i>Current tax relief</i> | 56 | 00 | 00 |
| <i>Deferred tax asset/(liability)</i> | 408 | (33) | 700 |
| Actuarial (losses)/gains recognised in post-retirement benefit schemes | (1,134) | 36 | (1,692) |
| <i>Currency translation adjustments and other movements</i> | (399) | 48 | 37 |
| <i>Revaluation of premises</i> | 56 | (69) | (33) |
| Other recognised (losses)/gains | (343) | (21) | 4 |
| Total recognised gains and losses in the year | 2,779 | 2,269 | 346 |
| Prior year adjustment arising from the implementation of FRS 17 | (2,001) | | |
| Total recognised gains and losses since 31 December 2003 | 778 | | |

Reconciliation of movements in consolidated shareholders' funds

for the year ended 31 December 2004

| | 2004 £m | 2003* £m | 2002* £m |
|--|--------------|--------------|----------------|
| Profit attributable to ordinary shareholders | 4,256 | 2,254 | 2,034 |
| Ordinary dividends | (1,837) | (1,490) | (1,267) |
| Retained profit for the year | 2,419 | 764 | 767 |
| Issue of ordinary and preference shares | 4,603 | 775 | 560 |
| Conversion of exchangeable undated loan capital | 460 | 00 | 00 |
| Redemption of preference shares | 00 | (364) | (600) |
| Actuarial (losses)/gains recognised in post-retirement benefit schemes | (1,134) | 36 | (1,692) |
| Own shares held in relation to employee share scheme | (7) | 00 | 00 |
| Goodwill previously written off to reserves | 00 | 40 | 00 |
| Other recognised gains and losses | (343) | (21) | 4 |
| Currency translation adjustment on share premium account | (231) | (203) | (283) |
| Net increase/(decrease) in shareholders' funds | 5,767 | 1,027 | (1,244) |

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| | | | |
|---|---------------|---------------|---------------|
| Opening shareholders' funds as previously reported | 28,099 | 27,052 | 26,668 |
| Prior year adjustment arising from the implementation of FRS 17 | (2,001) | (1,981) | (353) |
| Opening shareholders' funds as restated | 26,098 | 25,071 | 26,315 |
| Net increase/(decrease) in shareholders funds | 5,767 | 1,027 | (1,244) |
| Closing shareholders' funds | 31,865 | 26,098 | 25,071 |

* restated (see page 85)

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Consolidated cash flow statement

for the year ended 31 December 2004

| | Note | 2004 £m | 2004 £m | 2003 £m | 2003 £m | 2002 £m | 2002 £m |
|--|------|------------|------------|------------|------------|------------|------------|
| Net cash inflow from operating activities | 43 | | 6,307 | | 19,708 | | 13,737 |
| Dividends received from associated undertakings | | | 9 | | 9 | | 1 |
| Returns on investments and servicing of finance | | | | | | | |
| Preference dividends paid | | (253) | | (269) | | (317) | |
| Additional Value Shares dividend paid | | | | (1,463) | | (798) | |
| Dividends paid to minority shareholders in subsidiary undertakings | | (204) | | (130) | | (112) | |
| Interest paid on subordinated liabilities | | (613) | | (557) | | (674) | |
| Net cash outflow from returns on investments and servicing of finance | | | (1,070) | | (2,419) | | (1,901) |
| Taxation | | | | | | | |
| UK tax paid | | (812) | | (933) | | (833) | |
| Overseas tax paid | | (582) | | (521) | | (274) | |
| Net cash outflow from taxation | | | (1,394) | | (1,454) | | (1,107) |
| Capital expenditure and financial investment | | | | | | | |
| Purchase of investment securities | | (41,790) | | (44,861) | | (32,701) | |
| Sale and maturity of investment securities | | 43,022 | | 41,805 | | 26,072 | |
| Purchase of tangible fixed assets | | (4,354) | | (5,017) | | (3,367) | |
| Sale of tangible fixed assets | | 1,596 | | 1,108 | | 811 | |
| Net cash outflow from capital expenditure and financial investment | | | (1,526) | | (6,965) | | (9,185) |

Acquisitions and disposals

| | | | | |
|---|----|---------|---------|-------|
| Purchase of businesses and subsidiary undertakings (net of cash acquired) | 44 | (7,648) | (1,748) | (308) |
| Investment in associated undertakings | | (48) | (2) | (2) |
| Sale of subsidiary and associated undertakings (net of cash sold) | 45 | 22 | 179 | 29 |
| Net cash outflow from acquisitions and disposals | | (7,674) | (1,571) | (281) |
| Ordinary equity dividends paid | | (1,235) | (772) | (729) |
| Net cash (outflow)/inflow before financing | | (6,583) | 6,536 | 535 |
| Financing | | | | |
| Proceeds from issue of ordinary share capital | | 2,845 | 184 | 85 |
| Proceeds from issue of preference share capital | | 1,358 | □□ | □□ |
| Proceeds from issue of trust preferred securities | | 1,075 | 883 | 1,242 |
| Redemption of preference share capital | | □□ | (364) | (600) |
| Issue of subordinated liabilities | | 4,624 | 3,817 | 2,157 |
| Repayment of subordinated liabilities | | (718) | (336) | (202) |
| Increase/(decrease) in minority interests | | 185 | (56) | 29 |
| Net cash inflow from financing | | 9,369 | 4,128 | 2,711 |
| Increase in cash | 48 | 2,786 | 10,664 | 3,246 |
| | | 92 | | |

Balance sheet □ the company

at 31 December 2004

| | Note | 2004 £m | 2003 £m |
|--------------------------------|------|------------|------------|
| Fixed assets | | | |
| Investments: | | | |
| Shares in Group undertakings | 17 | 36,870 | 32,354 |
| Loans to Group undertakings | 18 | 4,101 | 4,554 |
| | | 40,971 | 36,908 |
| Current assets | | | |
| Debtors: | | | |
| Due by subsidiary undertakings | | 458 | 238 |
| Debtors and prepayments | | 174 | 202 |

| | | | |
|---|----|---------|---------|
| | | 632 | 440 |
| Creditors | | | |
| Amounts falling due within one year: | | | |
| Due to banks | | 66 | 71 |
| Dated loan capital | 30 | 40 | 40 |
| Debt securities in issue | | 1,608 | 1,877 |
| Other creditors | | 247 | 217 |
| Proposed final dividend | 7 | 1,308 | 1,059 |
| | | 3,269 | 3,264 |
| Net current liabilities | | (2,637) | (2,824) |
| Total assets less current liabilities | | 38,334 | 34,084 |
| Creditors | | | |
| Amounts falling due beyond one year: | | | |
| Loans from subsidiary undertakings | | 162 | 186 |
| Dated loan capital | 30 | 4,810 | 3,714 |
| Undated loan capital including convertible debt | 31 | 1,085 | 1,639 |
| | | 6,057 | 5,539 |
| Capital and reserves | | | |
| Called up share capital | 33 | 822 | 769 |
| Share premium account | 34 | 12,964 | 8,175 |
| Other reserves | 34 | 156 | 156 |
| Revaluation reserve | 34 | 14,970 | 16,857 |
| Profit and loss account | 34 | 3,365 | 2,588 |
| <i>Shareholders' funds</i> | | | |
| <i>equity</i> | | 27,757 | 25,622 |
| <i>non-equity</i> | 34 | 4,520 | 2,923 |
| | | 38,334 | 34,084 |

The accounts were approved by the Board of directors on 23 February 2005 and signed on its behalf by:

Sir George Mathewson
Chairman

Sir Fred Goodwin
Group Chief Executive

Fred Watt
Group Finance Director

Notes on the accounts

1 Dealing profits

| | 2004 £m | 2003* £m | 2002* £m |
|-------------------------------|--------------|--------------|--------------|
| Foreign exchange (1) | 616 | 540 | 447 |
| Securities | | | |
| Equities (2) | 36 | 24 | 18 |
| Debt (3) | 811 | 774 | 644 |
| Interest rate derivatives (4) | 525 | 455 | 353 |
| | 1,988 | 1,793 | 1,462 |

Dealing profits include interest income and expense recognised on trading-related interest-earning assets and interest-bearing liabilities and exclude direct costs and administrative expenses.

Notes:

- (1) Includes spot and forward foreign exchange contracts and currency swaps, futures and options and related hedges and funding.
- (2) Includes equities, equity derivatives, commodity contracts and related hedges and funding.
- (3) Includes debt securities and related hedges and funding.
- (4) Includes interest rate swaps, forward rate agreements, interest rate options, interest rate futures and credit derivatives and related hedges and funding.

2 Administrative expenses □ staff costs

| | 2004 £m | 2003* £m | 2002* £m |
|---------------------------------------|--------------|--------------|--------------|
| Wages, salaries and other staff costs | 4,543 | 3,997 | 4,001 |
| Social security costs | 295 | 248 | 239 |
| Pension costs (see Note 3) | 506 | 408 | 344 |
| | 5,344 | 4,653 | 4,584 |

* restated (see page 85)

The average number of persons employed by the Group during the year, excluding temporary staff, was 133,300 (2003 □ 119,500; 2002 □ 113,500).

3 Pension costs

The Group operates a number of pension schemes which are predominantly defined benefit schemes whose assets are independent of the Group's finances. In addition to the main scheme, The Royal Bank of Scotland Group Pension Fund, the Group operates a number of other UK and overseas pension schemes. It also provides other post-retirement benefits, principally through subscriptions to private healthcare schemes in the UK and the US and unfunded post-retirement benefit plans. Provision for the costs of these benefits is charged to the profit and loss account over the average remaining future service lives of the eligible

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employees. The amounts are not material.

The total pension costs for the Group were as follows:

| | Main UK scheme £m | Other schemes £m | 2004 Total £m | 2003 Total £m | 2002 Total £m |
|--|-------------------------|------------------------|---------------------|---------------------|---------------------|
| Amount charged to profit and loss account | | | | | |
| Expected return on pension scheme assets | (840) | (82) | (922) | (826) | (988) |
| Interest on pension scheme liabilities | 759 | 78 | 837 | 774 | 787 |
| Net return credited to other operating income | (81) | (4) | (85) | (52) | (201) |
| Current service cost | 400 | 51 | 451 | 371 | 322 |
| Past service cost | 00 | 11 | 11 | 00 | 3 |
| Net pension cost defined benefit schemes | 319 | 58 | 377 | 319 | 124 |
| Defined contribution schemes and other retirement benefits | 00 | 44 | 44 | 37 | 19 |
| Total net pension costs | 319 | 102 | 421 | 356 | 143 |

| | 2004 £m | 2003 £m | 2002 £m |
|---|------------|------------|------------|
| The total net pension costs are included in the profit and loss account as follows: | | | |
| Other operating income | (85) | (52) | (201) |
| Staff costs □ pension costs (see Note 2) | 506 | 408 | 344 |
| Total net pension costs | 421 | 356 | 143 |

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For the purposes of FRS 17, interim valuations of the Group's schemes were prepared to 31 December by independent actuaries, using the following assumptions:

| | 2004 | | 2003 | | Main UK scheme |
|---|-------------------|-------------------------|-------------------|-------------------------|-------------------|
| | Main UK scheme | Other Group schemes* | Main UK scheme | Other Group schemes* | |
| Rate of increase in salaries (per annum) | 3.95% | 3.6% | 3.95% | 3.8% | 3.50% |
| Rate of increase in pensions in payment (per annum) | 2.70% | 2.5% | 2.70% | 2.3% | 2.25% |
| Discount rate (per annum) | 5.40% | 5.2% | 5.60% | 5.8% | 5.75% |
| Inflation assumption (per annum) | 2.70% | 2.5% | 2.70% | 2.1% | 2.25% |

* weighted average

The assets and liabilities of the schemes were as follows:

2004 2003

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| | Main UK scheme £m | Other Group schemes £m | Main UK scheme £m | Other Group schemes £m | Main UK schemes £m |
|-------------------------------------|-------------------------|------------------------------|-------------------------|------------------------------|--------------------------|
| Equities | 7,713 | 777 | 7,621 | 686 | 7,161 |
| Bonds | 2,238 | 244 | 3,818 | 276 | 3,298 |
| Other | 3,647 | 208 | 383 | 103 | 223 |
| Total market value of assets | 13,598 | 1,229 | 11,822 | 1,065 | 10,682 |
| Present value of scheme liabilities | (16,051) | (1,626) | (13,594) | (1,261) | (12,418) |
| Net deficit in the schemes | (2,453) | (397) | (1,772) | (196) | (1,736) |
| Deferred tax asset | 905 | 78 | 532 | 22 | 521 |
| Net pension deficit | (1,548) | (319) | (1,240) | (174) | (1,215) |
| Other unfunded liabilities (net) | □□- | (34) | □□ | (31) | □ |
| Post-retirement benefit liabilities | (1,548) | (353) | (1,240) | (205) | (1,215) |

The assumptions for long-term rates of return on the principal classes of assets at 31 December 2004 were equities 8.1%, government bonds 5.4%, property 6.3% and cash and other assets 4.6% (2003 □ equities 8.4%, gilts 4.8%, other bonds 5.6%, property 6.3% and other assets 4.9%; 2002 □ equities 8.4%, gilts 4.5%, other bonds 5.75%, property 6.5% and cash 4.5%).

| | 2004 £m | 2003 £m |
|--|---------------------|---------------------|
| Amount recognised in the statement of consolidated total recognised gains and losses | | |
| Actual return less expected return on pension scheme assets | 411 | 872 |
| Experience gains and losses arising on scheme liabilities | (631) | 7 |
| Changes in assumptions underlying the present value of scheme liabilities | (1,378) | (810) |
| Actuarial (losses)/gains | (1,598) | 69 |
| Current tax relief | 56 | □ |
| Deferred tax asset/(liability) | 408 | (33) |
| Actuarial (losses)/gains recognised in post-retirement benefit schemes | (1,134) | 36 |
| | | |
| | 2004 Total £m | 2003 Total £m |
| Movement in pension schemes (deficits)/surpluses during the year | | |
| (Deficit)/surplus in the pension schemes at 1 January | (1,968) | (1,856) |
| Movement in year: | | |
| Current service cost | (451) | (371) |
| Past service cost | (11) | □ |
| Contributions | 1,145 | 139 |
| Other operating income | 85 | 52 |
| Actuarial (losses)/gains | (1,598) | 69 |
| Acquisition of subsidiaries | (32) | □ |
| Exchange and other movements | (20) | (1) |

| | | |
|-------------------------------------|---------|---------|
| Deficit in schemes at 31 December | (2,850) | (1,968) |
| Deferred tax asset | 983 | 554 |
| Net pension deficit | (1,867) | (1,414) |
| Other unfunded liabilities (net) | (34) | (31) |
| Post-retirement benefit liabilities | (1,901) | (1,445) |

Following the latest formal valuation carried out by independent actuaries as at 31 March 2004, the contribution rate with effect from 1 April 2004 for the main UK scheme is 21.5% of pensionable salaries (2003 and 2002 □ 6.8% based on the valuation as at 31 March 2001). Contributions for 2004 include a lump sum of £750 million paid into the Main Fund in addition to the monthly contributions.

Notes on the accounts continued

3 Pension costs (continued)

| History of experience gains and losses | 2004 £m | 2003 £m | 2002 £m |
|--|------------|------------|------------|
| Difference between expected and actual return on scheme assets: | | | |
| Amount | 411 | 872 | (2,645) |
| Percentage of scheme assets | 2.8% | 6.8% | (22.6%) |
| Experience gains and losses on scheme liabilities: | | | |
| Amount | (631) | 7 | (25) |
| Percentage of the present value of scheme liabilities | (3.6%) | □□ | (0.2%) |
| Total amount recognised in the statement of total recognised gains and losses: | | | |
| Amount | (1,598) | 69 | (2,392) |
| Percentage of the present value of scheme liabilities | (9.0%) | 0.5% | (17.7%) |

4 Profit on ordinary activities before tax

Profit on ordinary activities before tax is stated after taking account of the following:

| | 2004 £m | 2003 £m | 2002 £m |
|---|------------|------------|------------|
| Income | | | |
| Aggregate amounts receivable under finance leases, hire purchase and conditional sale contracts | 1,345 | 1,161 | 1,342 |
| Aggregate amounts receivable under operating leases | 1,103 | 939 | 811 |
| Profit on disposal of investment securities | 167 | 172 | 85 |
| Share of associated undertakings □ net profit | 35 | 12 | 2 |

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| | | | | |
|--------------------------------------|--|-----|-----|-----|
| Expenses | Operating lease rentals of premises | 338 | 321 | 255 |
| | Operating lease rentals of computers and other equipment | 15 | 13 | 16 |
| | Finance charges on leased assets | 13 | 8 | 23 |
| | Interest on subordinated liabilities | 681 | 551 | 659 |
| | Integration expenditure* relating to: | | | |
| | □ acquisition of NatWest | □□ | 143 | 810 |
| | □ other acquisitions | 269 | 86 | 147 |
| <hr/> | | | | |
| * Integration expenditure comprises: | | | | |
| | Staff costs | 113 | 125 | 530 |
| | Premises and equipment | 34 | 31 | 127 |
| | Other administrative expenses | 120 | 73 | 298 |
| | Depreciation | 2 | □□ | 2 |
| <hr/> | | | | |
| | | 269 | 229 | 957 |
| <hr/> | | | | |

Auditors' remuneration

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

| | 2004 £m | 2003 £m |
|--------------------------------------|------------|------------|
| Audit services | | |
| □ Statutory audit | 8.2 | 7.2 |
| □ Audit related regulatory reporting | 1.1 | 0.6 |
| | 9.3 | 7.8 |
| Further assurance services | 3.0 | 5.7 |
| Tax services | | |
| □ Compliance services | 0.2 | 0.1 |
| □ Advisory services | 0.2 | 0.5 |
| | 0.4 | 0.6 |
| Other services | 3.0 | 0.7 |
| Total | 15.7 | 14.8 |

The auditors' remuneration for statutory audit work for the company was £0.1 million (2003 □ £0.1 million). Non-audit fees paid to the auditors and their associates in the UK was £6.4 million (2003 □ £6.2 million).

5 Tax on profit on ordinary activities

| | 2004 £m | 2003 £m | 2002 £m |
|--|------------|------------|------------|
| Current taxation: | | | |
| UK corporation tax charge for the year at 30% | 1,305 | 1,095 | 909 |
| Over provision in respect of prior periods | (66) | (66) | (13) |
| Relief for overseas taxation | (212) | (211) | (26) |
| | 1,027 | 818 | 870 |
| Overseas taxation: | | | |
| Current year charge | 786 | 538 | 370 |
| Over provision in respect of prior periods | (102) | (11) | (2) |
| | 1,711 | 1,345 | 1,238 |
| Share of associated undertakings | 11 | 2 | 2 |
| Current tax charge for the year | 1,722 | 1,347 | 1,240 |
| Deferred taxation: | | | |
| Origination and reversal of timing differences | 482 | 576 | 398 |
| Over provision in respect of prior periods | (49) | (35) | (56) |
| Tax charge for the year | 2,155 | 1,888 | 1,582 |

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

| | 2004 £m | 2003 £m | 2002 £m |
|--|------------|------------|------------|
| Expected tax charge | 2,075 | 1,823 | 1,456 |
| Goodwill amortisation | 241 | 200 | 183 |
| Contributions to employee share schemes | (32) | (35) | (40) |
| Non-deductible items | 227 | 248 | 179 |
| Non-taxable items | (251) | (207) | (188) |
| Capital allowances in excess of depreciation | (415) | (626) | (340) |
| Taxable foreign exchange movements | (10) | 5 | 4 |
| Foreign profits taxed at other rates | 49 | 26 | 2 |
| Unutilised losses brought forward and carried forward | 6 | (15) | □□ |
| Current taxation adjustments relating to prior periods | (168) | (77) | (15) |
| Current tax charge for the year | 1,722 | 1,342 | 1,241 |
| Deferred taxation: | | | |
| Origination and reversal of timing differences | 482 | 581 | 397 |
| Adjustments in respect of prior periods | (49) | (35) | (56) |
| Actual tax charge | 2,155 | 1,888 | 1,582 |

The following factors may affect future tax charges:

- (1) No deferred tax is recognised on the unremitted reserves of overseas subsidiary and associated undertakings. A substantial proportion of such reserves are required to be retained by the overseas undertakings to meet local regulatory requirements.
- (2) Deferred tax assets of £110 million (2003 □ £127 million) resulting from tax losses carried forward have not been recognised as there is insufficient evidence that the asset will be recoverable. These assets may be recoverable if the losses can be offset against suitable future taxable profits arising in the same tax jurisdiction.
- (3) The fair values of certain financial assets are disclosed in Note 40. The tax that could be payable if these assets were disposed of at the values shown is estimated at £910 million (2003 □ £561 million). Because of the nature of these financial assets which are held as part of the banking business, it is not possible to determine the amount that may become payable in the foreseeable future.
- (4) Freehold and long leasehold properties are revalued (see Note 20). No provision has been made for deferred tax on gains recognised on revaluing Group properties except where there is a commitment to sell the asset and any taxable gain will not be subject to rollover relief. The tax that could be payable if these assets were disposed of at their revalued amount is estimated at £129 million (2003 □ £109 million), including tax on rolled over gains (see (5) below). No such tax is expected to be payable in the foreseeable future.
- (5) No provision has been made for deferred tax on certain gains realised on disposals of property and other assets as there is an expectation of rolling over such gains into replacement assets. Expenditure to date on valid replacement assets together with forecasts of future such expenditure indicate that these gains will be available for rollover relief. The tax that could be payable if the conditions for rollover relief were not met is estimated at £16 million (2003 □ £68 million).

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Notes on the accounts continued

6 Preference and Additional Value Shares dividends

| | 2004 £m | 2003 £m | 2002 £m |
|---|------------|--------------|------------|
| Non-cumulative preference shares of US\$0.01 | 105 | 99 | 141 |
| Non-cumulative convertible preference shares of US\$0.01 | 90 | 100 | 108 |
| Non-cumulative convertible preference shares of €0.01 | 33 | 37 | 32 |
| Non-cumulative preference shares of €0.01 | 4 | □□ | □□ |
| Non-cumulative convertible preference shares of £0.25 | □□ | □□ | 1 |
| Non-cumulative convertible preference shares of £0.01 | 15 | 15 | 15 |
| 11% cumulative preference shares of £1 (1) | □□ | □□ | □□ |
| 5.5% cumulative preference shares of £1 (2) | □□ | □□ | □□ |
| Appropriation for premium payable on redemption and issue costs | 9 | 10 | 8 |
| Total preference dividends | 256 | 261 | 305 |
| Additional Value Shares | □□ | 1,463 | 798 |

| | | | |
|----------------------------|-----|-------|-------|
| Total non-equity dividends | 256 | 1,724 | 1,103 |
|----------------------------|-----|-------|-------|

Notes:

- (1) Dividends for the year ended 31 December 2004 amounted to £55,000 (2003 and 2002 □ £55,000).
 (2) Dividends for the year ended 31 December 2004 amounted to £22,000 (2003 and 2002 □ £22,000).

7 Ordinary dividends

| | 2004 p per share | 2003 p per share | 2002 p per share | 2004 £m | 2003 £m | 2002 £m |
|----------------------------------|------------------------|------------------------|------------------------|------------|------------|------------|
| Interim | 16.8 | 14.6 | 12.7 | 529 | 431 | 368 |
| Proposed final | 41.2 | 35.7 | 31.0 | 1,308 | 1,059 | 899 |
| Total dividends on equity shares | 58.0 | 50.3 | 43.7 | 1,837 | 1,490 | 1,267 |

8 Profit dealt with in the accounts of the company

Of the profit attributable to shareholders, £2,878 million (2003 □ £2,619 million; 2002 □ £1,955 million) has been dealt with in the accounts of the company.

9 Earnings per ordinary share

The earnings per share are based on the following:

| | 2004 £m | 2003 £m | 2002 £m |
|---|-----------------------------|------------|------------|
| Earnings: | | | |
| Profit attributable to ordinary shareholders | 4,256 | 2,254 | 2,034 |
| Add back dividends on dilutive convertible non-equity shares | 66 | □□ | □□ |
| Diluted earnings attributable to ordinary shareholders | 4,322 | 2,254 | 2,034 |
| | Number of shares □ millions | | |
| Number of ordinary shares: | | | |
| Weighted average number of ordinary shares in issue during the year | 3,085 | 2,931 | 2,881 |
| Effect of dilutive share options and convertible non-equity shares | 73 | 22 | 43 |
| Diluted weighted average number of ordinary shares during the year | 3,158 | 2,953 | 2,924 |

10 Treasury bills and other eligible bills

| | 2004 £m | 2003 £m |
|---------------------------------------|--------------|--------------|
| Treasury bills and similar securities | 5,538 | 3,917 |
| Other eligible bills | 572 | 929 |
| | <u>6,110</u> | <u>4,846</u> |
| Banking business | 3,189 | 2,977 |
| Trading business | 2,921 | 1,869 |

Treasury and other eligible bills are principally of short-term maturity and their market value is not materially different from carrying value.

11 Loans and advances to banks

| | 2004 £m | 2003 £m |
|---|---------------|---------------|
| Repayable on demand | 19,430 | 17,115 |
| Remaining maturity | | |
| □ three months or less | 26,112 | 25,525 |
| □ one year or less but over three months | 11,902 | 8,357 |
| □ five years or less but over one year | 266 | 422 |
| □ over five years | 556 | 479 |
| | <u>58,266</u> | <u>51,898</u> |
| Specific bad and doubtful debt provisions | (6) | (7) |
| | <u>58,260</u> | <u>51,891</u> |
| Banking business | 22,354 | 21,358 |
| Trading business | 35,906 | 30,533 |

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Notes on the accounts continued**12 Loans and advances to customers**

| | |
|------------|------------|
| 2004 £m | 2003 £m |
|------------|------------|

| | | |
|--|---------|---------|
| On demand or short notice | 51,234 | 24,847 |
| Remaining maturity | | |
| □ three months or less | 89,784 | 64,281 |
| □ one year or less but over three months | 38,461 | 27,465 |
| □ five years or less but over one year | 53,543 | 40,908 |
| □ over five years | 116,669 | 98,952 |
| General and specific bad and doubtful debt provisions | 349,691 | 256,453 |
| | (4,222) | (3,922) |
| | 345,469 | 252,531 |
| Banking business | 283,233 | 223,456 |
| Trading business | 62,236 | 29,075 |
| Amounts above include: | | |
| Subordinated advances | 220 | 73 |
| Amounts receivable under finance leases | 9,968 | 8,405 |
| Amounts receivable under hire purchase and conditional sale agreements | 6,358 | 5,935 |

The cost of assets acquired during the year for the purpose of letting under finance leases and hire purchase agreements was £5,937 million (2003 □ £6,361 million).

The Group's exposure to risk from its lending activities is widely diversified both geographically and industrially. Lending to the services sector, house mortgage lending, loans to financial institutions, other personal loans and lending to property companies exceeded 10% of total loans and advances to customers (before provisions).

Residual value exposures

The table below gives details of the unguaranteed residual values included in the carrying value of finance lease receivables (see above) and operating lease assets (see Note 20).

| | Year in which the residual value will be recovered | | | | Total £m |
|------------------------------------|--|--|--|------------------------|-------------|
| | Within 1 year £m | After 1 year but within 2 years £m | After 2 years but within 5 years £m | After 5 years £m | |
| 2004 | | | | | |
| Operating leases | | | | | |
| Transportation | 69 | 387 | 1,260 | 2,603 | 4,319 |
| Cars and light commercial vehicles | 405 | 141 | 117 | □□ | 663 |
| Other | 14 | 19 | 65 | 11 | 109 |
| Finance leases | 34 | 33 | 70 | 355 | 492 |
| At 31 December 2004 | 522 | 580 | 1,512 | 2,969 | 5,583 |

| | Year in which the residual value will be recovered | | | | Total £m |
|------------------------------------|--|--|--|------------------------|-------------|
| | Within 1 year £m | After 1 year but within 2 years £m | After 2 years but within 5 years £m | After 5 years £m | |
| 2003 | | | | | |
| Operating leases | | | | | |
| Transportation | 548 | 198 | 481 | 2,344 | 3,571 |
| Cars and light commercial vehicles | 313 | 128 | 120 | □□ | 561 |
| Other | 11 | 21 | 54 | 96 | 182 |
| Finance leases | 62 | 21 | 85 | 158 | 326 |
| At 31 December 2003 | 934 | 368 | 740 | 2,598 | 4,640 |

Linked presentation

(i) Leveraged leases □ as part of the purchase of Charter One the Group acquired a portfolio of lease receivables that qualify as leveraged leases under US GAAP. Leveraged leases involve the Group as lessor obtaining non-recourse funding from third parties. This financing is secured on the underlying leases and the provider of the finance has no recourse whatsoever to the other assets of the Group. The Group is not obliged, and does not intend, to support losses that may be suffered by these third-party providers of funding. They have agreed in writing that they will be paid, as to interest and principal, only out of lease cash flows. At 31 December 2004, the gross value of leveraged leases amounted to £1,897 million and non-recourse financing received was £1,502 million. During the year the Group recognised net income of £13 million comprising interest receivable of £35 million less interest payable and other expenses of £22 million.

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ii) Mortgage securitisations □ following the acquisition of FirstActive in 2004, the Group is party to a number of mortgage securitisations that qualify for linked presentation. Mortgages have been transferred to special purpose vehicles, held ultimately by charitable trusts, funded principally through the issue of floating rate notes. The Group is not obliged, and does not intend, to support losses that may be suffered by the note holders. There are no arrangements for the Group to repurchase the mortgages. The note holders have agreed that they will be paid, as to interest and principal, only to the extent that sufficient funds are generated by the mortgage loans and their underlying security. The Group has entered into arm's length fixed/floating interest rate swaps with the securitisation vehicles and provides mortgage management and agency services to the vehicles. On repayment of the financing, any further amounts generated by the mortgages will be paid to the Group. At 31 December

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2004, mortgages of £1,519 million are subject to non-recourse finance of £1,479 million. During the year the Group recognised net income of £26 million comprising interest receivable of £72 million less interest payable and other expenses of £46 million.

(iii) Securitisation of housing association loans – the Group has arranged the securitisation of housing association loans. The loans were acquired by special purpose vehicles, held ultimately by charitable trusts, funded principally through the issue of floating and fixed rate notes. The Group is not obliged, and does not intend, to support losses that may be suffered by the note holders. The note holders have agreed that they will be paid, as to interest and principal, only to the extent that sufficient funds are generated by the loans and their underlying security. Any proceeds from the loans in excess of the amounts required to service and repay the notes are payable to the Group after deduction of expenses. At 31 December 2004, gross loans amounted to £1,412 million (2003 – £1,450 million) and notes held by third parties were £1,012 million (2003 – £861 million).

During the year the Group recognised net income of £37 million (2003 – £39 million; 2002 – £40 million) comprising interest receivable of £116 million (2003 – £119 million; 2002 – £118 million) less interest payable and other expenses of £79 million (2003 – £80 million; 2002 – £78 million).

(iv) Mortgage banking activities - the Group sells originated mortgage loans to US Agencies in return for securities backed by these loans and guaranteed by the Agency whilst retaining the rights to service the mortgages. These securities may be subsequently sold. The purchaser has recourse to the Group for losses up to pre-determined levels on certain designated mortgages. The Group is not obliged, and does not intend, to support losses that may be suffered by the Agencies. Under the terms of the sale agreements, the Agencies have agreed to seek repayment only from the cash from the mortgage loans. Once the securities exchanged for the loans have been sold the Group's exposure is restricted to the amount of the recourse and the transaction qualifies for the linked presentation. At 31 December 2004 mortgages amounting to £472 million had been sold with recourse and the related securities sold. Recourse is limited to a maximum of £6 million. No amounts were recognised in the profit and loss account except for income from the servicing of the mortgages.

(v) Loan transfer – during 2004, loans originated by the Group and another bank were transferred to a special purpose vehicle which funded the purchase through the issue of notes. The Group is not obliged, and does not intend, to support losses that may be suffered by the note holders. There are no arrangements for the Group to repurchase the loan. The note holders have agreed that they will be paid, as to interest and principal, only to the extent that sufficient funds are generated by the loans. At 31 December 2004, the gross loan amounted to £301 million and the non-recourse financing of £301 million. Gross and net income in 2004 were less than £1 million.

13 Provisions for bad and doubtful debts

| | Specific £m | General £m | 2004 Total £m | Specific £m | General £m | 2003 Total £m |
|---|----------------|---------------|---------------------|----------------|---------------|---------------------|
| At 1 January | 3,363 | 566 | 3,929 | 3,330 | 597 | 3,927 |
| Currency translation and other adjustments | (22) | (76) | (98) | (23) | (39) | (62) |
| Acquisition of subsidiary | 222 | 68 | 290 | 44 | 6 | 50 |
| Amounts written off | (1,468) | – | (1,468) | (1,519) | – | (1,519) |
| Recoveries of amounts written off in previous periods | 147 | – | 147 | 72 | – | 72 |
| Charge to profit and loss account | 1,412 | 16 | 1,428 | 1,459 | 2 | 1,461 |

| | | | | | | |
|----------------|-------|-----|-------|-------|-----|-------|
| At 31 December | 3,654 | 574 | 4,228 | 3,363 | 566 | 3,929 |
|----------------|-------|-----|-------|-------|-----|-------|

14 Interest in suspense

In certain cases, interest may be charged to a customer's account but, because its recoverability is in doubt, not recognised in the Group's consolidated profit and loss account. Such interest is held in a suspense account and netted off against loans and advances in the consolidated balance sheet.

| | 2004 £m | 2003 £m |
|---|------------|------------|
| Loans and advances on which interest is being placed in suspense: | | |
| □ before specific provisions | 2,558 | 1,938 |
| □ after specific provisions | 1,203 | 930 |
| Loans and advances on which interest is not being applied: | | |
| □ before specific provisions | 2,225 | 2,494 |
| □ after specific provisions | 850 | 980 |

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Notes on the accounts continued**15 Debt securities**

| | 2004 Book value £m | Gross unrecognised gains £m | Gross unrecognised losses £m | 2004 Valuation £m | 2003 Book value £m | Gross unrecognised gains £m | Gross unrecognised losses £m |
|----------------------------|-----------------------------|--------------------------------------|---------------------------------------|-------------------------|-----------------------------|--------------------------------------|---------------------------------------|
| Investment securities: | | | | | | | |
| UK government | 760 | 2 | (22) | 740 | 1,516 | 1 | |
| Other government | 14,138 | 85 | (44) | 14,179 | 12,442 | 101 | |
| Other public sector bodies | 309 | 1 | | 310 | 422 | 4 | |
| Bank and building society | 9,319 | 3 | (4) | 9,318 | 11,690 | 4 | |
| Other issuers | 10,537 | 78 | (285) | 10,330 | 15,464 | 130 | |
| | 35,063 | 169 | (355) | 34,877 | 41,534 | 240 | |
| Other debt securities: | | | | | | | |
| UK government | 1,502 | | | 1,502 | 1,246 | | |
| Other government | 12,457 | | | 12,457 | 10,819 | | |
| Other public sector bodies | 37 | | | 37 | 36 | | |
| Bank and building society | 604 | | | 604 | 407 | | |
| Other issuers | 41,548 | | | 41,548 | 25,907 | | |

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| | | | | |
|--|--------|--|--------|--------|
| | 56,148 | | 56,148 | 38,415 |
| | 91,211 | | 91,025 | 79,949 |
| Due within one year | 18,060 | | | 16,943 |
| Due one year and over | 73,151 | | | 63,006 |
| | 91,211 | | | 79,949 |
| Investment securities: | | | | |
| Listed | 25,201 | | 25,198 | 33,067 |
| Unlisted | 9,862 | | 9,679 | 8,467 |
| | 35,063 | | 34,877 | 41,534 |
| Other debt securities: | | | | |
| Listed | 28,714 | | 28,714 | 16,307 |
| Unlisted | 27,434 | | 27,434 | 22,108 |
| | 91,211 | | 91,025 | 79,949 |
| Banking business | 36,485 | | | 42,374 |
| Trading business | 54,726 | | | 37,575 |
| Amounts above include: | | | | |
| Subordinated debt securities | 664 | | | 890 |
| Unamortised discounts less premiums on investment securities | 1 | | | 3 |

The cost of securities carried at market value is not disclosed because it cannot be determined without unreasonable effort.

Movements in debt securities which are held as investment securities were as follows:

| | Cost £m | Discounts and premiums £m | Provisions £m | Book value £m |
|--|------------|------------------------------------|------------------|---------------------|
| At 1 January 2004 | 41,440 | 216 | (122) | 41,534 |
| Currency translation and other adjustments | (1,610) | (18) | 2 | (1,626) |
| Additions | 41,217 | 0 | 0 | 41,217 |
| Acquisition of subsidiaries | 4,013 | (6) | 0 | 4,007 |
| Maturities and disposals | (42,529) | (48) | 10 | (42,567) |
| Provisions made net of write backs | 0 | 0 | (71) | (71) |
| Transfers to other debt securities | (7,429) | 6 | 1 | (7,422) |
| Amortisation of discounts and premiums | 0 | (9) | 0 | (9) |
| Amounts written off | (16) | 0 | 16 | 0 |

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At 31 December 2004

35,086 141 (164) 35,063

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The following table categorises the Group's investment debt securities by maturity and yield (based on weighted averages) at 31 December 2004:

| | Within 1 year | | After 1 but within 5 years | | After 5 but within 10 years | | After 10 years | | Total | |
|---|---------------|------------|----------------------------|------------|-----------------------------|------------|----------------|------------|---------------|------------|
| | Amount £m | Yield % | Amount £m | Yield % | Amount £m | Yield % | Amount £m | Yield % | Amount £m | Yield % |
| UK government | 61 | 8.2 | 489 | 5.9 | 184 | 5.7 | 26 | 2.5 | 760 | 5.9 |
| US treasury and other US government | 254 | 1.4 | 326 | 2.2 | 944 | 2.6 | 11,185 | 3.0 | 12,709 | 3.0 |
| Other government | 442 | 1.7 | 617 | 3.9 | 314 | 3.8 | 4 | 5.7 | 1,377 | 3.2 |
| Securities issued by the states of the US | 0 | 0 | 18 | 4.9 | 16 | 4.1 | 18 | 3.4 | 52 | 4.1 |
| Other public sector bodies | 99 | 1.0 | 8 | 4.6 | 202 | 2.0 | 0 | 0 | 309 | 1.7 |
| Corporate debt securities | 750 | 3.5 | 982 | 3.8 | 227 | 4.0 | 224 | 4.9 | 2,183 | 3.8 |
| Mortgage-backed securities | 12 | 2.5 | 211 | 7.0 | 1,168 | 3.4 | 3,473 | 4.1 | 4,864 | 4.1 |
| Bank and building society | 8,158 | 5.2 | 1,089 | 3.4 | 44 | 5.0 | 28 | 5.3 | 9,319 | 5.0 |
| Other | 1,768 | 4.0 | 1,421 | 5.4 | 221 | 2.5 | 80 | 2.1 | 3,490 | 4.5 |
| Total book value | 11,544 | 4.6 | 5,161 | 4.4 | 3,320 | 3.2 | 15,038 | 3.3 | 35,063 | 3.9 |
| Total fair value | 11,297 | | 5,201 | | 3,288 | | 15,091 | | 34,877 | |

Gross gains of £101 million (2003 □ £158 million) and gross losses of £30 million (2003 □ £47 million) were realised on the sale and redemption of investment debt securities.

16 Equity shares

| | 2004 Book value £m | Gross unrecognised gains £m | Gross unrecognised losses £m | 2004 Valuation £m | 2003 Book value £m | Gross unrecognised gains £m | Gross unrecognised losses £m | 2003 Valuation £m |
|------------------------|-----------------------------|--------------------------------------|---------------------------------------|-------------------------|-----------------------------|--------------------------------------|---------------------------------------|-------------------------|
| Investment securities: | | | | | | | | |
| Listed | 1,213 | 356 | (78) | 1,491 | 1,157 | 350 | (88) | 1,419 |
| Unlisted | 1,227 | 169 | (5) | 1,391 | 664 | 174 | (19) | 819 |
| | 2,440 | 525 | (83) | 2,882 | 1,821 | 524 | (107) | 2,238 |
| Other securities: | | | | | | | | |
| Listed | 519 | 0 | 0 | 519 | 465 | 0 | 0 | 465 |
| Unlisted | 1 | 0 | 0 | 1 | 14 | 0 | 0 | 14 |

| | | | | | | | | |
|------------------|-------|-----|------|-------|-------|-----|-------|-------|
| | 2,960 | 525 | (83) | 3,402 | 2,300 | 524 | (107) | 2,717 |
| Banking business | 2,474 | | | | 1,872 | | | |
| Trading business | 486 | | | | 428 | | | |

The cost of securities carried at market value is not disclosed because it cannot be determined without unreasonable expense.

Movements in equity shares which are held as investment securities were as follows:

| | Cost £m | Provisions £m | Book value £m |
|--|------------|------------------|------------------|
| At 1 January 2004 | 1,940 | (119) | 1,821 |
| Currency translation and other adjustments | (61) | 5 | (56) |
| Additions | 573 | 0 | 573 |
| Acquisition of subsidiaries | 381 | 0 | 381 |
| Disposals | (288) | 0 | (288) |
| Amounts written off | (10) | 10 | 0 |
| Provisions made net of write backs | 0 | (12) | (12) |
| Transfers | 21 | 0 | 21 |
| At 31 December 2004 | 2,556 | (116) | 2,440 |

Gross gains of £96 million (2003 □ £68 million) and gross losses of nil (2003 □ £7 million) were realised on the sale of investment equity shares.

Notes on the accounts continued

17 Shares in Group undertakings

Movements in shares in Group undertakings during the year were as follows:

| | £m |
|----------------------------------|---------|
| At 1 January 2004 | 32,354 |
| Currency translation adjustments | (399) |
| Additions | 6,802 |
| Revaluation | (1,887) |

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At 31 December 2004

36,870

On the historical cost basis, shares in Group undertakings at 31 December 2004 would have been included at a cost of £22,301 million (2003 □ £15,499 million).

The principal subsidiary undertakings of the company are shown below. Their capital consists of ordinary and preference shares which are unlisted with the exception of certain preference shares issued by NatWest. The Royal Bank and RBS Insurance Group Limited are directly owned by the company, and all of the other subsidiary undertakings are owned directly, or indirectly through intermediate holding companies, by these companies and are all wholly-owned. All of these subsidiaries are included in the Group's consolidated financial statements and have an accounting reference date of 31 December.

| | Nature of business | Country of incorporation and principal area of operation |
|-----------------------------------|--------------------|--|
| The Royal Bank of Scotland plc | Banking | Great Britain |
| National Westminster Bank Plc (1) | Banking | Great Britain |
| Citizens Financial Group, Inc. | Banking | US |
| Coutts & Co (2) | Private banking | Great Britain |
| Greenwich Capital Markets, Inc. | Broker dealer | US |
| RBS Insurance Group Limited | Insurance | Great Britain |
| Ulster Bank Limited (3) | Banking | Northern Ireland |

Notes:

- (1) The company does not hold any of the NatWest preference shares in issue.
- (2) Coutts & Co is incorporated with unlimited liability. Its registered office is 440 Strand, London WC2R 0Q5.
- (3) Ulster Bank Limited and its subsidiary undertakings also operate in the Republic of Ireland.

The above information is provided in relation to the principal related undertakings as permitted by Section 231(5) of the Companies Act 1985. Full information on all related undertakings will be included in the Annual Return filed with the UK Companies House.

18 Loans to Group undertakings

Movements during the year:

£m

| | |
|--|-------|
| At 1 January 2004 | 4,554 |
| Currency translation and other adjustments | (216) |
| Additions | 350 |
| Repayments | (587) |
| <hr/> | |
| At 31 December 2004 | 4,101 |

19 Intangible fixed assets

| | |
|--|--------|
| Goodwill | £m |
| <hr/> | |
| Cost: | |
| At 1 January 2004 | 15,758 |
| Currency translation and other adjustments | (558) |
| Arising on acquisitions during the year | 5,899 |
| Disposals | (20) |
| <hr/> | |
| At 31 December 2004 | 21,079 |
| <hr/> | |
| Amortisation: | |
| At 1 January 2004 | 2,627 |
| Currency translation and other adjustments | (35) |
| Charge for the year | 915 |
| Disposals | (4) |
| <hr/> | |
| At 31 December 2004 | 3,503 |
| <hr/> | |
| Net book value at 31 December 2004 | 17,576 |
| <hr/> | |
| Net book value at 31 December 2003 | 13,131 |

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Notes on the accounts continued**20 Tangible fixed assets**

| | Freehold premises £m | Long leasehold premises £m | Short leasehold premises £m | Computers and other equipment £m | Assets on operating leases £m | Total £m |
|--|-------------------------|-------------------------------|--------------------------------|-------------------------------------|----------------------------------|-------------|
| Cost or valuation: | | | | | | |
| At 1 January 2004 | 5,217 | 1,346 | 655 | 2,911 | 7,548 | 17,677 |
| Currency translation and other adjustments | (18) | | (10) | (41) | (185) | (254) |

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| | | | | | | |
|---|--------------|--------------|------------|--------------|--------------|---------------|
| Reclassifications | 1 | (5) | (5) | 9 | 00 | 00 |
| Acquisition of subsidiaries | 152 | 32 | 41 | 133 | 487 | 845 |
| Additions | 589 | 21 | 212 | 691 | 2,841 | 4,354 |
| Disposals and write-off of fully depreciated assets | (302) | (21) | (48) | (136) | (1,352) | (1,859) |
| Revaluation adjustments | 16 | 2 | 00 | 00 | 00 | 18 |
| At 31 December 2004 | 5,655 | 1,375 | 845 | 3,567 | 9,339 | 20,781 |
| Consisting of: | | | | | | |
| At valuation 2004 | 2,754 | 1,129 | 00 | 00 | 00 | 3,883 |
| 2003 and prior | 821 | 134 | 00 | 00 | 00 | 955 |
| At cost | 2,080 | 112 | 845 | 3,567 | 9,339 | 15,943 |
| At 31 December 2004 | 5,655 | 1,375 | 845 | 3,567 | 9,339 | 20,781 |
| Accumulated depreciation and amortisation: | | | | | | |
| At 1 January 2004 | 407 | 94 | 250 | 1,805 | 1,194 | 3,750 |
| Currency translation and other adjustments | (1) | 3 | (3) | (17) | (29) | (47) |
| Reclassifications | 00 | 00 | (2) | 2 | 00 | 00 |
| Acquisition of subsidiaries | 00 | 5 | 00 | 14 | 28 | 47 |
| Disposals and write-off of fully depreciated assets | (19) | (2) | (4) | (56) | (251) | (332) |
| Charge for the year | 60 | 11 | 42 | 355 | 639 | 1,107 |
| Revaluation adjustments | (19) | (19) | 00 | 00 | 00 | (38) |
| At 31 December 2004 | 428 | 92 | 283 | 2,103 | 1,581 | 4,487 |
| Net book value at 31 December 2004 | 5,227 | 1,283 | 562 | 1,464 | 7,758 | 16,294 |
| Net book value at 31 December 2003 | 4,810 | 1,252 | 405 | 1,106 | 6,354 | 13,927 |

On the historical cost basis, the Group's freehold and long leasehold premises would have been included at £6,249 million (2003 £5,886 million).

Freehold and long leasehold properties are revalued on a rolling basis, each property being valued at least every five years. Interim valuations outwith the five year cycle are carried out on properties where there is an indication that their value has changed significantly, given market conditions. The directors are not aware of any material change in the valuation of the Group's properties and therefore no additional interim valuations were required.

Properties occupied by the Group are valued on the basis of Existing Use Value, except for certain specialised properties which are valued on a Depreciated Replacement Cost basis. Investment properties and properties to be disposed of are valued to reflect Open Market Value. Valuations are carried out by internal and external qualified surveyors who are members of the Royal Institution of Chartered Surveyors or, in the case of some overseas properties, locally qualified valuers.

| | | |
|-----------------|------|------|
| Net book value: | 2004 | 2003 |
| | £m | £m |

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| | | |
|---|--------------|--------------|
| Land and buildings occupied for own use | 2,768 | 2,391 |
| Investment properties | 3,715 | 3,628 |
| Properties under development | 570 | 429 |
| Properties to be disposed of | 19 | 19 |
| | 7,072 | 6,467 |
| Net book value of assets held under finance leases | 18 | 90 |
| Depreciation for the year of assets held under finance leases | 2 | 20 |
| Contracts for future capital expenditure not provided for in the accounts at the year end | | |
| Premises and equipment | 406 | 104 |
| Assets on operating leases | 196 | 498 |
| | 602 | 602 |

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21 Other assets

| | 2004 £m | 2003* £m |
|-----------------------------------|---------------|---------------|
| Trading derivatives (see Note 39) | 17,884 | 14,087 |
| Other | 4,371 | 3,720 |
| | 22,255 | 17,807 |

*restated (see page 85)

22 Long-term assurance business

The long-term assurance assets and liabilities attributable to policyholders comprise:

| | 2004 £m | 2003 £m |
|----------------------------|--------------|--------------|
| Investments | 4,309 | 4,005 |
| Value of in-force policies | 418 | 413 |
| | 4,727 | 4,418 |

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| | | |
|--|-------|-------|
| Long-term assurance business attributable to shareholders* | (927) | (861) |
| | 3,800 | 3,557 |

The increase in the shareholders' interest in the long-term assurance business included in the profit and loss account is calculated as follows:

| | 2004 £m | 2003 £m |
|---|------------|------------|
| Increase in value for the year before tax | 94 | 73 |
| Tax | (28) | (22) |
| Increase in value for the year after tax | 66 | 51 |

* The value of the long-term assurance business is calculated by discounting estimated future flows of statutory profits from in-force business at a discount rate that includes a risk margin. The future flows are based on prudent assumptions about long-term economic and business experience determined with the advice of qualified actuaries. The risk margin is designed to reflect uncertainties in expected future flows.

The key assumptions used are:

| | 2004 % | 2003 % |
|--|-----------|-----------|
| Risk discount rate (net of tax) | 8.0 | 8.5 |
| Growth of unit-linked funds (gross of tax) | 6.9 | 6.7 |
| Growth of non-unit-linked funds (gross of tax) | 4.7 | 5.0 |
| Basic tax rate | 20.0 | 20.0 |
| Shareholder taxation - life | 30.0 | 30.0 |
| Expense inflation | 3.5 | 3.5 |

23 Deposits by banks

| | 2004 £m | 2003 £m |
|--|------------|------------|
| Repayable on demand | 30,279 | 20,995 |
| With agreed maturity dates or periods of notice, by remaining maturity | | |
| - three months or less | 53,296 | 42,300 |
| - one year or less but over three months | 10,474 | 2,268 |
| - five years or less but over one year | 3,675 | 122 |
| - over five years | 1,357 | 1,638 |
| | 99,081 | 67,323 |
| Banking business | 59,399 | 41,061 |
| Trading business | 39,682 | 26,262 |

Notes on the accounts continued**24 Customer accounts**

| | 2004 £m | 2003 £m |
|--|------------|------------|
| Repayable on demand | 193,988 | 160,574 |
| With agreed maturity dates or periods of notice, by remaining maturity | | |
| □ three months or less | 66,542 | 64,797 |
| □ one year or less but over three months | 15,502 | 7,608 |
| □ five years or less but over one year | 7,803 | 3,288 |
| □ over five years | 1,227 | 696 |
| | 285,062 | 236,963 |
| Banking business | 243,929 | 210,925 |
| Trading business | 41,133 | 26,038 |

25 Debt securities in issue

| | 2004 £m | 2003 £m |
|---|------------|------------|
| Bonds and medium term notes, by remaining maturity | | |
| □ one year or less | 7,736 | 2,227 |
| □ two years or less but over one year | 3,034 | 1,063 |
| □ five years or less but over two years | 3,606 | 3,614 |
| □ over five years | 1,328 | 3,525 |
| | 15,704 | 10,429 |
| Other debt securities in issue, by remaining maturity | | |
| □ three months or less | 31,849 | 23,414 |
| □ one year or less but over three months | 9,786 | 6,188 |
| □ two years or less but over one year | 1,598 | 977 |
| □ five years or less but over two years | 23 | 8 |
| | 43,256 | 30,587 |
| | 58,960 | 41,016 |
| Banking business | 57,200 | 39,899 |
| Trading business | 1,760 | 1,117 |

26 Settlement balances and short positions

| | 2004 £m | 2003 £m |
|---|---------------|---------------|
| Settlement balances | 4,067 | 2,241 |
| Short positions: | | |
| Debt securities □ Government | 24,619 | 16,631 |
| □ Other issuers | 4,002 | 2,423 |
| Treasury bills and other eligible bills | 302 | 74 |
| | 32,990 | 21,369 |

27 Other liabilities

| | 2004 £m | 2003 £m |
|-----------------------------------|---------------|---------------|
| Notes in circulation | 1,351 | 1,394 |
| Trading derivatives (see Note 39) | 19,034 | 15,173 |
| Current taxation | 677 | 700 |
| Dividends | 1,357 | 1,105 |
| Other liabilities | 3,733 | 2,212 |
| | 26,152 | 20,584 |

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28 Deferred taxation

Provision for deferred taxation has been made as follows:

| | 2004 £m | 2003 £m |
|--|--------------|--------------|
| Deferred tax liability | 2,873 | 2,036 |
| Deferred tax asset (included in Note 21, Other assets) | (47) | (48) |
| Net deferred tax | 2,826 | 1,988 |
| | 2004 £m | 2003 £m |
| Short-term timing differences | (56) | (49) |
| Capital allowances | 3,248 | 2,440 |
| Bad and doubtful debt provisions | (399) | (441) |

| | | |
|---|-------|-------|
| Deferred gains | 33 | 38 |
| Net deferred tax | 2,826 | 1,988 |
| Movements during the year: | £m | |
| As previously reported | 2,238 | |
| Prior year adjustment arising on implementation of FRS 17 | (250) | |
| At 1 January 2004 as restated | 1,988 | |
| Currency translation and other adjustments | (66) | |
| Acquisition of subsidiaries | 514 | |
| Disposal of lease receivables | (43) | |
| Charge to profit and loss account | 433 | |
| At 31 December 2004 | 2,826 | |

The deferred taxation balance at 31 December 2004 does not include any amounts in respect of the Group's post-retirement benefit liabilities which is shown on the balance sheet after deduction of a deferred taxation asset of £995 million (2003 - £566 million)(see Note 3). The opening provision for deferred taxation has been restated following implementation of FRS 17 (see page 85).

29 Other provisions

| | Property(1) £m | Pensions and other similar obligations £m | Other(2) £m | Total £m |
|---|-------------------|--|----------------|-------------|
| As previously reported | 179 | 43 | 34 | 256 |
| Prior year adjustment arising on implementation of FRS 17 | 0 | (43) | 0 | (43) |
| At 1 January 2004 as restated | 179 | 0 | 34 | 213 |
| Acquisition of subsidiaries | 0 | 0 | 12 | 12 |
| Charge to profit and loss account | 18 | 0 | 2 | 20 |
| Provisions utilised | (33) | 0 | (14) | (47) |
| At 31 December 2004 | 164 | 0 | 34 | 198 |

Notes:

- (1) The Group has a number of leasehold properties where rents payable and other unavoidable costs exceed the value to the Group. Such costs arise over the period of the lease or to the expected termination date, and the provision has been discounted due to the long-term nature of certain of these obligations.
- (2) Other provisions arise in the normal course of business.

Notes on the accounts continued

30 Dated loan capital

| | 2004 £m | 2003 £m |
|---|---------------|---------------|
| The company | | |
| £200 million floating rate (minimum 5.25%) notes 2005 (1,2) | 40 | 80 |
| US\$400 million 6.4% subordinated notes 2009 (1) | 206 | 223 |
| US\$300 million 6.375% subordinated notes 2011 (1) | 154 | 166 |
| US\$750 million 5% subordinated notes 2013 | 385 | 416 |
| US\$750 million 5% subordinated notes 2014 (1) | 385 | 417 |
| US\$250 million 5% subordinated notes 2014 (1) | 127 | 137 |
| US\$675 million 5.05% subordinated notes 2015 (issued December 2004) (3) | 347 | □□ |
| US\$350 million 4.7% subordinated notes 2018 (1) | 180 | 195 |
| | 1,824* | 1,634* |
| The Royal Bank of Scotland plc | | |
| £125 million subordinated floating rate notes 2005 (4) | 125 | 125 |
| £150 million 8.375% subordinated notes 2007 | 150 | 149 |
| DEM500 million (redesignated €255 million) 5.25% subordinated notes 2008 | 180 | 180 |
| €300 million 4.875% subordinated notes 2009 | 211 | 211 |
| US\$150 million floating rate notes 2009 (5) | □□ | 84 |
| £35 million floating rate step-up subordinated notes 2010 | 35 | 35 |
| US\$350 million floating rate subordinated notes 2012 | 181 | 196 |
| €130 million floating rate subordinated notes 2012 | 92 | 92 |
| US\$500 million floating rate subordinated notes 2012 | 258 | 280 |
| £150 million 10.5% subordinated bonds 2013 (6) | 150 | 149 |
| €1,000 million 6.0% subordinated notes 2013 | 699 | 700 |
| €500 million 6.0% subordinated notes 2013 | 360 | 362 |
| US\$50 million floating rate subordinated notes 2013 | 26 | 28 |
| €1,000 million floating rate subordinated notes 2013 (callable October 2008) | 704 | 705 |
| US\$1,250 million floating rate subordinated notes 2014 (issued May 2004; callable July 2009) (7) | 646 | □□ |
| A\$590 million 6.0% subordinated notes 2014 (issued October 2004; callable October 2009) (8) | 238 | □□ |
| A\$410 million floating rate subordinated notes 2014 (issued October 2004; callable October 2009) (9) | 165 | □□ |
| £250 million 9.625% subordinated bonds 2015 | 248 | 248 |
| €750 million 4.875% subordinated notes 2015 | 528 | 529 |
| US\$500 million floating rate subordinated notes 2016 (issued October 2004; callable October 2011) (10) | 258 | □□ |
| €500 million 4.5% subordinated notes 2016 (callable January 2011) | 351 | 351 |
| €100 million floating rate subordinated notes 2017 | 71 | 70 |
| US\$125.6 million floating rate subordinated notes 2020 | 65 | 70 |
| €1,000 million 4.625% subordinated notes 2021 (issued September 2004; callable September 2016) (11) | 695 | □□ |
| RBSG Capital Corporation | | |
| US\$250 million 10.125% guaranteed capital notes 2004 (12) | □□ | 140 |

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| | | |
|--|--------|-------|
| National Westminster Bank Plc | | |
| £100 million 12.5% subordinated unsecured loan stock 2004 (13) | □□ | 104 |
| US\$400 million guaranteed floating rate capital notes 2005 | 206 | 223 |
| US\$1,000 million 7.375% subordinated notes 2009 | 513 | 553 |
| US\$650 million floating rate subordinated step-up notes 2009 (14) | □□ | 366 |
| €600 million 6.0% subordinated notes 2010 | 420 | 419 |
| £300 million 8.125% step-up subordinated notes 2011 (callable December 2006) | 301 | 303 |
| €500 million 5.125% subordinated notes 2011 | 346 | 341 |
| £300 million 7.875% subordinated notes 2015 | 304 | 309 |
| £300 million 6.5% subordinated notes 2021 | 296 | 297 |
| Greenwich Capital Holdings, Inc. | | |
| US\$105 million subordinated loan capital 2004 floating rate notes | □□ | 59 |
| US\$105 million subordinated loan capital 2006 floating rate notes | 54 | □□ |
| Charter One Financial, Inc. (15) | | |
| US\$400 million 6.375% subordinated notes 2012 | 226 | □□ |
| First Active plc (16) | | |
| US\$35 million 7.24% subordinated bonds 2012 (callable December 2007) | 22 | □□ |
| £60 million 6.375% subordinated bonds 2018 (callable April 2013) | 65 | □□ |
| | 11,013 | 9,312 |

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| | 2004 £m | 2003 £m |
|---|------------|------------|
| Dated loan capital in issue, by remaining maturity is repayable as follows: | | |
| □ in one year or less | 371 | 709 |
| □ in two years or less but over one year | 355 | 388 |
| □ in five years or less but over two years | 3,035 | 1,337 |
| □ in more than five years | 7,252 | 6,878 |
| | 11,013 | 9,312 |

*In addition, the company issued 1.25 million subordinated loan notes of €1,000 each in June 2002, 750,000 subordinated loan notes of US\$1,000 each in December 2002, 850,000 subordinated loan notes of US\$1,000 each in May 2003, 650,000 subordinated loan notes of US\$1,000 each in December 2003, 1.5 million subordinated loan notes of US\$1,000 each in August 2004 and 450,000 subordinated loan notes of US\$1,000 each in September 2004 to

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subsidiaries of the Group. These loan notes are included in the company balance sheet within loan capital but are reclassified as non-equity minority interests on consolidation (see Note 32).

Notes:

- (1) On-lent to The Royal Bank of Scotland plc on a subordinated basis.
- (2) Repayable in five equal annual instalments in May in each of the years 2001 to 2005.
- (3) Net proceeds received US\$672 million, £349 million.
- (4) Repayable in whole, at the option of The Royal Bank of Scotland plc, prior to maturity, on conditions governing the respective debt obligation, including prior approval of the UK Financial Services Authority.
- (5) Redeemed in October 2004.
- (6) Unconditionally guaranteed by the company.
- (7) Net proceeds received US\$1,250 million, £698 million.
- (8) Net proceeds received A\$589 million, £240 million.
- (9) Net proceeds received A\$409 million, £167 million.
- (10) Net proceeds received US\$500 million, £278 million.
- (11) Net proceeds received €986 million, £673 million.
- (12) Redeemed in March 2004.
- (13) Redeemed in July 2004.
- (14) Redeemed in October 2004.
- (15) Arising from acquisition of Charter One.
- (16) Arising from acquisition of First Active.
- (17) In the event of certain changes in the tax laws of the UK, all of the dated loan capital issues are redeemable in whole, but not in part, at the option of the issuer, at the principal amount thereof plus accrued interest, subject to prior approval of the UK Financial Services Authority.
- (18) Except as stated above, claims in respect of the Group's dated loan capital are subordinated to the claims of other creditors. None of the Group's dated loan capital is secured.
- (19) Interest payable on the Group's floating rate dated issues is at a margin over London interbank rates. Interest on £1,450 million, US\$4,425 million, €5,405 million and A\$590 million of fixed rate dated issues is swapped into floating rates at a margin over London interbank rates.

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Notes on the accounts continued

31 Undated loan capital including convertible debt

| | 2004 £m | 2003 £m |
|---|------------|------------|
| <hr/> | | |
| The company | | |
| US\$350 million undated floating rate primary capital notes (callable on any interest payment date) (1,2) | 181 | 196 |
| US\$200 million 8.5% exchangeable capital securities, Series A (callable June 2004) (1,3) | 103 | 112 |
| US\$50 million undated 7.993% capital securities (callable November 2005) (1) | 26 | 28 |
| US\$35 million undated 7.755% capital securities (callable December 2005) (1) | 18 | 19 |
| US\$200 million undated 7.375% reset capital securities (callable April 2006) (1) | 103 | 112 |
| US\$75 million floating rate perpetual capital securities (callable September 2007) (1) | 39 | 42 |
| US\$850 million 5.75% exchangeable capital securities, Series B (4) | □□ | 464 |
| US\$1,200 million 7.648% perpetual regulatory tier one securities (callable September 2031) (1,5) | 615 | 666 |
| | <hr/> | |
| | 1,085 | 1,639 |
| The Royal Bank of Scotland plc | | |
| £125 million 9.25% undated subordinated step-up notes (callable April 2006) | 125 | 125 |

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| | | |
|--|--------------|--------------|
| £150 million undated subordinated floating rate step-up notes (callable March 2007) | 150 | 150 |
| FRF1,000 million (redesignated €152 million) 5.875% undated subordinated notes (callable October 2008) | 107 | 107 |
| £175 million 7.375% undated subordinated notes (callable August 2010) | 174 | 173 |
| £350 million 6.25% undated subordinated notes (callable December 2012) | 348 | 348 |
| €500 million 5.125% subordinated notes (issued July 2004; callable July 2014) (6) | 350 | □□ |
| €1,000 million floating rate subordinated notes (issued July 2004; callable July 2014) (7) | 701 | □□ |
| £500 million 6.0% subordinated notes (issued June 2004; callable September 2014) (8) | 496 | □□ |
| £500 million 5.125% undated subordinated notes (callable March 2016) | 491 | 491 |
| £200 million 9.5% undated subordinated bonds (callable August 2018) (9) | 198 | 198 |
| £600 million 5.5% subordinated notes (issued December 2004; callable December 2019) (10) | 595 | □□ |
| £500 million 6.2% undated subordinated notes (callable March 2022) | 497 | 497 |
| £300 million 5.625% undated subordinated notes (callable September 2026) | 298 | 298 |
| £200 million 5.625% undated subordinated notes (callable September 2026) | 210 | 211 |
| £400 million 5.625% undated subordinated notes (callable September 2026) | 397 | 396 |
| £350 million 5.625% undated subordinated notes (callable June 2032) | 346 | 346 |
| £150 million 5.625% undated subordinated notes (callable June 2032) | 144 | 144 |
| JPY25 billion 2.605% subordinated notes (issued November 2004; callable November 2034) (11) | 126 | □□ |
| National Westminster Bank Plc | | |
| US\$500 million primary capital floating rate notes, Series A (callable on any interest payment date) | 258 | 280 |
| US\$500 million primary capital floating rate notes, Series B (callable on any interest payment date) | 258 | 280 |
| US\$500 million primary capital floating rate notes, Series C (callable on any interest payment date) | 258 | 280 |
| US\$500 million 7.875% exchangeable capital securities (callable on any interest payment date) (12) | 258 | 280 |
| US\$500 million 7.75% reset subordinated notes (callable October 2007) | 255 | 275 |
| €100 million floating rate undated subordinated step-up notes (callable October 2009) | 71 | 70 |
| €400 million 6.625% fixed/floating rate undated subordinated notes (callable October 2009) | 280 | 280 |
| £325 million 7.625% undated subordinated step-up notes (callable January 2010) | 329 | 330 |
| £200 million 7.125% undated subordinated step-up notes (callable October 2022) | 203 | 203 |
| £200 million 11.5% undated subordinated notes (callable December 2022) (13) | 281 | 285 |
| First Active plc (14) | | |
| £20 million 11.75% perpetual tier two capital | 24 | □□ |
| IR£30 million 11.375% perpetual tier two capital | 38 | □□ |
| £1.3 million floating rate perpetual tier two capital | 2 | □□ |
| | 9,353 | 7,686 |

Notes:

- (1) On-lent to The Royal Bank of Scotland plc on a subordinated basis.
- (2) Interest is payable at a rate of 0.25% per annum over an average calculated by reference to six month euro dollar deposits in London for each interest period.
- (3) Redeemable in certain circumstances related to changes in the tax laws of the UK, in whole or in part, at the option of the company on any interest payment date. Exchangeable, in whole or in part, at the option of the company on any

- interest payment date, or in certain circumstances related to changes in the tax laws of the UK, in whole but not in part, into the company's non-cumulative preference shares of US\$0.01 each.
- (4) Exchanged for 34 million non-cumulative dollar preference shares of US\$0.01, Series L on 30 September 2004.
- (5) Redeemable by the company on or after 30 September 2031 or on any interest payment date thereafter or at any time on the occurrence of certain events, subject to the prior approval of the UK Financial Services Authority. Interest on the PROs is payable semi-annually in arrears at a fixed rate of 7.648% per annum until 30 September 2031 and thereafter quarterly in arrears at a variable rate of 2.5% per annum above three month dollar LIBOR. The company can satisfy interest payment obligations by issuing ordinary shares to appointed Trustees sufficient to enable them, on selling these shares, to settle the interest payment.
- (6) Net proceeds received €496 million, £334 million.
- (7) Net proceeds received €994 million, £668 million.
- (8) Net proceeds received £495 million.
- (9) Guaranteed by the company.
- (10) Net proceeds received £595 million.
- (11) Net proceeds received JPY25 billion, £127 million.
- (12) Exchangeable at the option of the issuer into 20 million 8.75% (gross) non-cumulative preference shares of US\$25 each of National Westminster Bank Plc at any time.
- (13) Exchangeable at the option of the issuer into 200 million 8.392% (gross) non-cumulative preference shares of £1 each of National Westminster Bank Plc at any time.
- (14) Arising from acquisition of First Active.
- (15) Except as stated above, claims in respect of the Group's undated loan capital are subordinated to the claims of other creditors. None of the Group's undated loan capital is secured.
- (16) Except as stated above, interest payable on Group floating rate undated issues is at a margin over London interbank rates. Interest on £4,875 million, US\$1,668 million, €1,052 million and JPY25 billion of fixed rate undated issues is swapped into floating rates at a margin over London interbank rates.
- (17) Where the issuer has the ability to redeem the undated loan capital, this is subject to prior approval of the UK Financial Services Authority.

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32 Minority interests – non-equity

| | 2004 £m | 2003 £m |
|--|--------------|--------------|
| Non-equity shares issued by NatWest: | | |
| Non-cumulative preference shares of US\$25 (1) | 278 | 299 |
| Non-cumulative preference shares of £1 (2) | 166 | 166 |
| | 444 | 465 |
| Non-equity shares issued by other subsidiaries: | | |
| Non-cumulative trust preferred securities of €1,000 (3) | 875 | 875 |
| Non-cumulative trust preferred securities of US\$1,000 (3) | 2,152 | 1,245 |
| Other non-equity minority interests | 200 | 139 |
| Total | 3,671 | 2,724 |

Notes:

- (1) The US\$250 million non-cumulative preference shares, Series B, of US\$25 each carry a gross dividend of 8.75% inclusive of associated tax credit. They are redeemable at the option of NatWest at US\$25 per share.

The US\$300 million non-cumulative preference shares, Series C, of US\$25 each carry a gross dividend of 8.625% inclusive of associated tax credit. They are redeemable at the option of NatWest from 9 April 2002 to 8 April 2008 inclusive, at a premium per share of US\$0.60 in 2005 reducing by US\$0.30 in each successive year. There is no

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redemption premium if the date of redemption falls after 8 April 2007.

- (2) The £140 million 9% non-cumulative preference shares, Series A, of £1 each are non-redeemable.
 (3) Wholly-owned subsidiaries of the Group have issued the following non-cumulative trust preferred securities:

| Issue | Number of securities in issue | Distribution rate per annum | Distribution frequency | Redemption date on or after | Redemption price per security |
|--|-------------------------------|--|------------------------|-------------------------------------|-------------------------------|
| Trust preferred securities of €1.000 | 1,250,000 | 6.467% | Annually | 30 June 2012 | €1,000 |
| Trust preferred securities of US\$1.000 | 750,000 | 6.8% | Quarterly | 31 March 2008 | US\$1,000 |
| Trust preferred securities of US\$1.000 | 850,000 | 4.709% | Semi-annually | 1 July 2013 | US\$1,000 |
| Trust preferred securities of US\$1.000 | 650,000 | 6.425% | Semi-annually | 3 January 2034 30 September 2014 | US\$1,000 |
| Trust preferred securities of US\$1.000* | 950,000 | 5.512% | Semi-annually | 30 September 2014 | US\$1,000 |
| Trust preferred securities of US\$1.000* | 1,000,000 | 0.80% above three month US\$ LIBOR | Quarterly | 30 September 2014 | US\$1,000 |

These securities have no maturity date and are not redeemable at the option of the holders at any time. The securities may, with the consent of the FSA, be redeemed, in whole or in part, by the issuer on the dates specified above or on any interest payment date thereafter. They may also be redeemed in whole, but not in part, upon the occurrence of certain tax and regulatory events.

*issued in 2004, net proceeds received US\$941 million (£523 million) and US\$994 (£552 million), respectively.

- (4) Minority interests in the consolidated profit and loss account includes £138 million (2003 □ £127 million; 2002 □ £67 million) in respect of non-equity interests.

33 Share capital

| | Allotted, called up and fully paid | | | Authorised | |
|--|------------------------------------|------------------------------|------------------------|------------------------|------------------------|
| | 1 January 2004 £m | Issued during the year £m | 31 December 2004 £m | 31 December 2004 £m | 31 December 2003 £m |
| Equity shares | | | | | |
| Ordinary shares of 25p | 740 | 53 | 793 | 1,020 | 1,020 |
| Non-voting deferred shares of £0.01 | 27 | □□ | 27 | 323 | 323 |
| Total equity share capital | 767 | 53 | 820 | 1,343 | 1,343 |
| Non-equity shares | | | | | |
| Additional Value Shares of £0.01 | □□ | □□ | □□ | 27 | 27 |
| Non-cumulative preference shares of US\$0.01 | 1 | □□ | 1 | 2 | 2 |
| Non-cumulative convertible preference shares of US\$0.01 | □□ | □□ | □□ | □□ | □□ |
| Non-cumulative preference shares of €0.01 | □□ | □□ | □□ | □□ | □□ |
| | □□ | □□ | □□ | □□ | □□ |

| | | | | | |
|---|------------|-----------|------------|--------------|--------------|
| Non-cumulative convertible preference shares of €0.01 | | | | | |
| Non-cumulative convertible preference shares of £0.25 | 00 | 00 | 00 | 225 | 225 |
| Non-cumulative convertible preference shares of £0.01 | 00 | 00 | 00 | 00 | 00 |
| Cumulative preference shares of £1 | 1 | 00 | 1 | 1 | 1 |
| Non-cumulative preference shares of £1 | 00 | 00 | 00 | 300 | 300 |
| Total non-equity share capital | 2 | 00 | 2 | 555 | 555 |
| Total share capital | 769 | 53 | 822 | 1,898 | 1,898 |

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Notes on the accounts continued

33 Share capital (continued)

| | Allotted, called up and fully paid | | Authorised | |
|--|------------------------------------|-----------|------------|------------|
| | 2004 | 2003 | 2004 | 2003 |
| Number of shares in thousands | | | | |
| Equity shares | | | | |
| Ordinary shares of 25p | 3,172,605 | 2,963,335 | 4,079,375 | 4,079,375 |
| Non-voting deferred shares of £0.01 | 2,660,556 | 2,660,556 | 32,300,000 | 32,300,000 |
| Non-equity shares | | | | |
| Additional Value Shares of £0.01 | 00 | 00 | 2,700,000 | 2,700,000 |
| Non-cumulative preference shares of US\$0.01 | 153,000 | 82,000 | 348,500 | 238,500 |
| Non-cumulative convertible preference shares of US\$0.01 | 1,900 | 1,900 | 3,900 | 3,900 |
| Non-cumulative preference shares of €0.01 | 1,250 | 00 | 66,000 | 66,000 |
| Non-cumulative convertible preference shares of €0.01 | 750 | 750 | 3,000 | 3,000 |
| Non-cumulative convertible preference shares of £0.25 | 00 | 00 | 900,000 | 900,000 |
| Non-cumulative convertible preference shares of £0.01 | 200 | 200 | 1,000 | 1,000 |
| Cumulative preference shares of £1 | 900 | 900 | 900 | 900 |
| Non-cumulative preference shares of £1 | 00 | 00 | 300,000 | 300,000 |

Ordinary shares

The following issues of ordinary shares were made during the year to 31 December 2004:

- (a) 165 million ordinary shares were placed at an issue price of £16.20 per share;
- (b) 12.9 million ordinary shares following the exercise of options under the company's executive, sharesave and option 2000 schemes and a further 5.6 million ordinary shares in respect of the exercise of options under the NatWest executive and sharesave schemes which had been exchanged for options over the company's shares following the acquisition of NatWest;
- (c) 23.4 million ordinary shares in lieu of cash in respect of the final dividend for the year ended 31 December 2003 and the interim dividend for the year ended 31 December 2004; and
- (d) 2.4 million ordinary shares under the company's profit sharing (share ownership) scheme.

Consideration of £2,845 million was received on the issue of ordinary shares for cash and dividends of £394 million were satisfied by the issue of shares.

During the year to 31 December 2004, options were granted over 16.7 million ordinary shares under the company's executive, sharesave and option 2000 schemes. At 31 December 2004, options granted under the company's various schemes, exercisable up to 2014 at prices ranging from 461p to 1841p per share, were outstanding in respect of 70.1 million ordinary shares.

In addition, options granted under the NatWest schemes were outstanding in respect of 1.6 million ordinary shares exercisable up to 2009 at prices ranging from 373p to 924p per share. As permitted by UITF 17 "Employee share schemes" applicable to SAYE schemes, no cost has been recognised in respect of sharesave options.

Preference shares

In August 2004, the company issued 37 million Series M non-cumulative preference shares of US\$0.01 each at US\$25 per share, the net proceeds being US\$896 million.

In September 2004, the company exchanged all of the outstanding US\$850 million 5.75% exchangeable capital securities, Series B, into 34 million Series L non-cumulative preference shares of US\$0.01 each, at US\$25 per share.

In November 2004, the company issued 1.25 million Series 1 non-cumulative preference shares of €0.01 each at €1,000 per share, the net proceeds being €1,225 million.

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Non-cumulative preference shares

Non-cumulative preference shares entitle the holders thereof to receive, subject to the company's Articles of Association, periodic non-cumulative cash dividends at specified fixed rates for each Series payable out of distributable profits of the company.

The non-cumulative preference shares are redeemable at the option of the company, in whole or in part from time to time at the rates detailed below plus dividends otherwise payable for the then current dividend period accrued to the date of redemption.

Class of preference share

Series

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| | | Number of shares in issue | Redemption date on or after | Redemption price per share | |
|---|--|---------------------------------|-----------------------------------|----------------------------------|-----------|
| Non-cumulative preference shares of US\$0.01 | Series D | 7 million | 14 September 2005 | US\$25.00 | |
| | Series E | 8 million | 17 October 2006 | US\$25.00 | |
| | Series F | 8 million | 31 March 2007 | US\$25.00 | |
| | Series G | 10 million | 31 March 2003 | US\$25.00 | |
| | Series H | 12 million | 31 March 2004 | US\$25.00 | |
| | Series I | 12 million | 30 September 2004 | US\$25.00 | |
| | Series J | 9 million | 31 December 2004 | US\$25.00 | |
| | Series K | 16 million | 30 June 2006 | US\$25.00 | |
| | Series L | 34 million | 30 September 2009 | US\$25.00 | |
| | Series M | 37 million | 30 September 2009 | US\$25.00 | |
| | Non-cumulative convertible preference shares of US\$0.01 | Series 1 | 1 million | 31 March 2010 | US\$1,000 |
| | | Series 2 | 0.5 million | 31 March 2005 | US\$1,000 |
| | | Series 3 | 0.4 million | 31 December 2005 | US\$1,000 |
| Non-cumulative convertible preference shares of €0.01 | Series 1 | 0.75 million | 31 March 2005 | €1,000 | |
| | Series 1 | 1.25 million | 31 December 2009 | €1,000 | |
| Non-cumulative preference shares of €0.01 | Series 1 | million | 2009 | €1,000 | |
| Non-cumulative convertible preference shares of £0.01 | Series 1 | 0.2 million | 31 December 2010 | £1,000 | |

In the event that the non-cumulative convertible preference shares are not redeemed on or before the redemption date, the holder may convert the non-cumulative convertible preference shares into ordinary shares in the company.

Under existing arrangements, no redemption or purchase of any non-cumulative preference shares may be made by the company without the prior consent of the UK Financial Services Authority.

On a winding-up or liquidation of the company, the holders of the non-cumulative preference shares will be entitled to receive, out of any surplus assets available for distribution to the company's shareholders (after payment of arrears of dividends on the cumulative preference shares up to the date of repayment) pari passu with the cumulative preference shares, the non-cumulative sterling preference shares and all other shares of the company ranking pari passu with the non-cumulative preference shares as regards participation in the surplus assets of the company, a liquidation distribution of US\$25 per non-cumulative preference share of US\$0.01, US\$1,000 per non-cumulative convertible preference share of US\$0.01, €1,000 per non-cumulative convertible preference share of €0.01 and £1,000 per non-cumulative convertible preference share of £0.01, together with an amount equal to dividends for the then current dividend period accrued to the date of payment, before any distribution or payment may be made to holders of the ordinary shares as regards participation in the surplus assets of the company.

Except as described above, the holders of the non-cumulative preference shares have no right to participate in the surplus assets of the company.

Holders of the non-cumulative preference shares are not entitled to receive notice of or attend general meetings of the company except if any resolution is proposed for adoption by the shareholders of the company to vary or abrogate any of the rights attaching to the non-cumulative preference shares or proposing the winding-up or liquidation of the company. In any such case, they are entitled to receive

notice of and to attend the general meeting of shareholders at which such resolution is to be proposed and will be entitled to speak and vote on such resolution (but not on any other resolution). In addition, in the event that, prior to any general meeting of shareholders, the company has failed to pay in full the three most recent quarterly dividend payments due on the non-cumulative dollar preference shares, the two most recent semi-annual dividend payments due on the non-cumulative convertible dollar preference shares and the most recent annual dividend payments due on the non-cumulative convertible euro preference shares and on the non-cumulative convertible sterling preference shares, the holders shall be entitled to receive notice of, attend, speak and vote at such meeting on all matters together with the holders of the ordinary shares, and in these circumstances only, the rights of the holders of the non-cumulative preference shares so to vote shall continue until the company shall have resumed the payment in full of the dividends in arrears.

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Notes on the accounts continued

34 Reserves

| | 2004 The Group £m | 2003 The Group £m | 2002 The Group £m | 2004 The company £m |
|--|----------------------------|----------------------------|----------------------------|------------------------------|
| Share premium account | | | | |
| At 1 January | 8,175 | 7,608 | 7,465 | 8,175 |
| Currency translation adjustments | (231) | (203) | (283) | (231) |
| Shares issued during the year | 4,550 | 760 | 685 | 4,550 |
| Conversion of exchangeable undated loan capital | 460 | 00 | 00 | 460 |
| Preference shares redeemed during the year | 00 | 00 | (268) | 00 |
| Other movements | 10 | 10 | 9 | 10 |
| At 31 December | 12,964 | 8,175 | 7,608 | 12,964 |
| Merger reserve | | | | |
| At 1 January | 10,881 | 11,455 | 12,029 | 00 |
| Transfer to profit and loss account | (574) | (574) | (574) | 00 |
| At 31 December | 10,307 | 10,881 | 11,455 | 00 |
| Other reserves | | | | |
| At 1 January | 419 | 387 | 212 | 156 |
| Redemption of preference shares | 00 | 00 | 150 | 00 |
| Transfer of increase in value of long-term life assurance business | 38 | 32 | 25 | 00 |
| At 31 December | 457 | 419 | 387 | 156 |
| Revaluation reserve | | | | |
| At 1 January | 7 | 80 | 113 | 16,857 |

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| | | | | |
|--|--------------|--------------|--------------|---------------|
| Revaluation of interests in subsidiary undertakings | 00 | 00 | 00 | (1,887) |
| Revaluation of premises | 56 | (69) | (33) | 00 |
| Transfer from/(to) profit and loss account | 29 | (4) | 00 | 00 |
| At 31 December | 92 | 7 | 80 | 14,970 |
| Profit and loss account | | | | |
| As previously reported | 7,848 | 6,768 | 5,956 | 2,588 |
| Prior year adjustment arising on implementation of FRS 17 | (2,001) | (1,981) | (353) | - |
| At 1 January as restated | 5,847 | 4,787 | 5,603 | 2,588 |
| Currency translation adjustments and other movements | (409) | 38 | 28 | (1) |
| Retention for the year | 2,419 | 764 | 767 | 785 |
| Employee share option payments | 00 | 00 | (136) | 00 |
| Redemption of preference shares | 00 | (364) | (332) | 00 |
| Actuarial (losses)/gains recognised in post-retirement benefit schemes | (1,134) | 36 | (1,692) | 00 |
| Own shares held in relation to employee share schemes | (7) | 00 | 00 | (7) |
| Goodwill previously written off | 00 | 40 | 00 | 00 |
| Transfer from merger reserve | 574 | 574 | 574 | 00 |
| Transfer of increase in value of long-term life assurance business | (38) | (32) | (25) | 00 |
| Transfer (to)/from revaluation reserve | (29) | 4 | 00 | 00 |
| At 31 December | 7,223 | 5,847 | 4,787 | 3,365 |

The cumulative goodwill arising on acquisitions of subsidiary and associated undertakings which are still part of the Group and written off directly against profit and loss account reserves of the Group amounted to £1,133 million at 31 December 2004.

Exchange gains of £1,024 million (2003 £604 million) arising on foreign currency borrowings have been offset in the Group's profit and loss account reserves against differences on retranslating the net investment in overseas subsidiary and associated undertakings financed by these borrowings.

The tax effect of gains and losses taken directly to reserves was nil (2003 nil).

Included in the closing balances of the Group's revaluation reserves and profit and loss account at 31 December 2004 are cumulative net losses of £320 million (2003 net gains £90 million) relating to the retranslation of opening net assets of subsidiary and associated undertakings offset by foreign currency borrowing.

At 31 December 2004, 707,247 (2003 790,019) ordinary shares of 25p each of the company were held by the 1992 Employee Share Trust and 63,098 (2003 nil) ordinary shares of 25p each were held by the 2001 Employee Share Trust in respect of options under the executive option scheme and awards under the medium term performance plan.

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| | 2004 £m | 2003 £m |
|--|------------|------------|
| Non-cumulative preference shares of US\$0.01 | 1,951 | 1,140 |
| Non-cumulative convertible preference shares of US\$0.01 | 978 | 1,058 |
| Non-cumulative preference shares of €0.01 | 864 | |
| Non-cumulative convertible preference shares of €0.01 | 529 | 528 |
| Non-cumulative convertible preference shares of £0.01 | 197 | 196 |
| Cumulative preference shares of £1 | 1 | 1 |
| | 4,520 | 2,923 |

35 Lease commitments

The annual rental commitments of the Group under non-cancellable operating leases were as follows:

| | 2004 | | 2003 | |
|-------------------------------------|----------|-----------|----------|-----------|
| | Premises | Equipment | Premises | Equipment |
| | £m | £m | £m | £m |
| Expiring within one year | 10 | 3 | 7 | 6 |
| Expiring between one and five years | 57 | 12 | 39 | 9 |
| Expiring after five years | 201 | 45 | 200 | 1 |
| | 268 | 60 | 246 | 16 |

36 Analysis of total assets and liabilities

| | | 2004 £m | 2003 £m |
|--------------|---|------------|------------|
| Assets: | denominated in sterling | 276,291 | 232,779 |
| | denominated in currencies other than sterling | 307,176 | 221,649 |
| | | 583,467 | 454,428 |
| Liabilities: | denominated in sterling | 271,410 | 233,493 |
| | denominated in currencies other than sterling | 312,057 | 220,935 |
| | | 583,467 | 454,428 |

37 Collateral given and received under repurchase transactions

The Group enters into securities repurchase agreements and securities lending transactions under which it receives or transfers cash or securities as collateral in accordance with normal market practice. Securities transferred under repurchase transactions included within securities on the balance sheet were as follows:

| | 2004 £m | 2003 £m |
|--|------------|------------|
| | | |

| | | |
|-----------------------------------|---------------|---------------|
| Treasury and other eligible bills | 1,593 | 761 |
| Debt securities | 32,129 | 24,231 |
| | <u>33,722</u> | <u>24,992</u> |

All of the above securities could be resold or repledged by the holder. Securities received as collateral under reverse repurchase agreements amounted to £91.4 billion (2003 £57.7 billion), of which £85.1 billion (2003 £53.6 billion) had been resold or repledged as collateral for the Group's own transactions.

Notes on the accounts continued

38 Assets charged as security for liabilities

| Assets charged as security for liabilities | 2004 £m | 2003 £m |
|--|---------------|--------------|
| Loans and advances to customers | 11,509 | 1,196 |
| Debt securities | 4,344 | 2,628 |
| Tangible fixed assets | 1,268 | 1,162 |
| Loans to banks | | 73 |
| Other | | 53 |
| | <u>17,121</u> | <u>5,112</u> |

Included above are assets pledged with overseas government agencies and banks, and margin deposits placed with exchanges.

| Liabilities secured by charges on assets | 2004 £m | 2003 £m |
|--|--------------|--------------|
| Deposits by banks | 5,628 | 3,000 |
| Customer accounts | 2,001 | 92 |
| Debt securities in issue | 1,522 | 1,550 |
| | <u>9,151</u> | <u>4,642</u> |

39 Derivatives

In the normal course of business, the Group enters into a variety of derivative transactions principally in the foreign exchange and interest rate markets. These are used to provide financial services to customers and to take, hedge and modify positions as part of trading activities. Derivatives are also used to hedge or modify risk exposures arising on the balance sheet from a variety of activities including lending and securities investment.

The principal types of derivative contracts into which the Group enters are described below.

Swaps

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These are over-the-counter (OTC) agreements between two parties to exchange periodic payments of interest, or payments for the change in value of a commodity, or related index, over a set period based on notional principal amounts. The Group enters into swap transactions in several markets. Interest rate swaps exchange fixed rates for floating rates of interest based on notional amounts. Basis swaps exchange floating or fixed interest calculated using different bases. Cross currency swaps are the exchange of interest based on notional values of different currencies. Equity and commodity swaps exchange interest for the return on an equity or commodity, or equity or commodity index.

Options

Currency and interest rate options confer the right, but not the obligation, on the buyer to receive or pay a specific quantity of an asset or financial instrument for a specified price at or before a specified date. Options may be exchange traded or OTC agreements. The Group principally buys and sells currency and interest rate options.

Futures and forwards

Short-term interest rate futures, bond futures and forward foreign exchange contracts are all agreements to deliver, or take delivery of, a specified amount of an asset or financial instrument based on the specified rate, price or index applied against the underlying asset or financial instrument, at a specified date. Futures are exchange traded at standardised amounts of the underlying asset or financial instrument. Forward contracts are OTC agreements and are principally dealt in by the Group in interest rates as forward rate agreements and in currency as forward foreign exchange contracts.

Collateral

The Group may require collateral in respect of the credit risk in derivative transactions. The amount of credit risk is principally the positive fair value of contracts. Collateral may be in the form of cash or in the form of a lien over a customer's assets entitling the Group to make a claim for current and future liabilities.

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Maturity of replacement cost of over-the-counter contracts (trading and non-trading)

Replacement cost indicates the Group's derivatives credit exposure. The following table sets forth the gross positive fair values by maturity. The net replacement cost of internal trades is not included as there is no credit risk associated with them.

| | Within one year £m | One to two years £m | Two to five years £m | Over five years £m | 2004 Total £m | Within one year £m | One to two years £m | Two to five years £m | Over five years £m | 2003 Total £m |
|--------------------------------|--------------------------|------------------------------|-------------------------------|-----------------------------|---------------------|--------------------------|------------------------------|-------------------------------|-----------------------------|---------------------|
| Before netting: | | | | | | | | | | |
| Exchange rate contracts | 21,812 | 2,369 | 3,045 | 2,018 | 29,244 | 22,315 | 2,245 | 2,028 | 1,575 | 28,163 |
| Interest rate contracts | 6,781 | 7,447 | 17,501 | 27,304 | 59,033 | 8,440 | 7,401 | 17,462 | 21,671 | 54,974 |
| Credit derivatives | | 15 | 92 | 157 | 264 | 11 | 7 | 85 | 169 | 272 |
| Equity and commodity contracts | 623 | 130 | 675 | 13 | 1,441 | 102 | 590 | 319 | 9 | 1,020 |
| | 29,216 | 9,961 | 21,313 | 29,492 | 89,982 | 30,868 | 10,243 | 19,894 | 23,424 | 84,429 |
| Banks and investment firms | | | | | 70,501 | | | | | 70,421 |

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| | | |
|--------|--------|--------|
| Others | 19,481 | 14,008 |
| | 89,982 | 84,429 |

At 31 December 2004, the potential credit risk exposure, which is after netting and allowing for collateral received, of the Group's trading and non-trading derivatives, was £6,290 million (2003 £5,405 million) to banks and investment firms and £7,900 million (2003 £5,985 million) to other counterparties.

Exchange traded contracts are excluded from the above table. Such contracts generally involve lower credit risk than OTC contracts as they are cleared through exchanges that require margin from participants and the daily settlement of gains and losses.

Trading derivatives

The following table shows the fair values of instruments in the derivatives trading portfolio:

| | 2004 | | 2003 | |
|--|--------------------------|--------------------|--------------------------|--------------------|
| | End of period fair value | | End of period fair value | |
| | Assets £m | Liabilities £m | Assets £m | Liabilities £m |
| Exchange rate contracts: | | | | |
| Spot, forwards and futures | 17,133 | 18,566 | 18,299 | 20,325 |
| Currency swaps | 6,281 | 6,314 | 5,183 | 4,944 |
| Options purchased | 5,797 | | 4,620 | |
| Options written | | 5,324 | | 4,295 |
| | 29,211 | 30,204 | 28,102 | 29,564 |
| Interest rate contracts: | | | | |
| Interest rate swaps | 55,001 | 55,360 | 50,838 | 50,744 |
| Options purchased | 3,168 | | 2,799 | |
| Options written | | 3,274 | | 2,829 |
| Futures and forwards | 475 | 479 | 629 | 639 |
| | 58,644 | 59,113 | 54,266 | 54,212 |
| Credit derivatives | 264 | 285 | 273 | 155 |
| Equity and commodity contracts | 1,274 | 941 | 924 | 720 |
| Netting | 89,393 (71,509) | 90,543 (71,509) | 83,565 (69,478) | 84,651 (69,478) |
| | 17,884 | 19,034 | 14,087 | 15,173 |
| Average fair values (before netting): | | | | |
| Exchange rate contracts | 20,050 | 21,193 | 18,967 | 19,619 |

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| | | | | |
|--------------------------------|--------|--------|--------|--------|
| Interest rate contracts | 55,548 | 56,258 | 65,676 | 65,977 |
| Credit derivatives | 219 | 177 | 365 | 133 |
| Equity and commodity contracts | 1,325 | 920 | 877 | 624 |
| | 77,142 | 78,548 | 85,885 | 86,353 |

Gains and losses on exchange traded contracts subject to daily margining requirements are settled daily. The fair value of such contracts included above reflects the last day's variation margin.

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Notes on the accounts continued

39 Derivatives (continued)

The following table analyses, by maturity and contract type, the notional principal amounts of the Group's trading derivatives:

| | Within one year £bn | One to two years £bn | Two to five years £bn | Over five years £bn | 2004 Total £bn | Within one year £bn | One to two years £bn | Two to five years £bn | Over five years £bn | 2003 Total £bn |
|---------------------------------------|---------------------------|----------------------------|-----------------------------|---------------------------|----------------------|---------------------------|-------------------------------|-----------------------------|------------------------------|----------------------|
| Exchange rate contracts: | | | | | | | | | | |
| Spot, forwards and futures | 707.5 | 27.7 | 10.4 | 0.5 | 746.1 | 616.8 | 24.9 | 7.2 | 0.2 | 649.1 |
| Currency swaps | 49.5 | 31.1 | 54.3 | 42.7 | 177.6 | 43.5 | 26.0 | 43.4 | 33.3 | 146.2 |
| Options purchased | 214.9 | 13.1 | 13.1 | 1.7 | 242.8 | 156.1 | 10.5 | 4.1 | 1.0 | 171.7 |
| Options written | 223.1 | 19.2 | 12.3 | 1.6 | 256.2 | 164.7 | 8.5 | 3.4 | 1.1 | 177.7 |
| | 1,195.0 | 91.1 | 90.1 | 46.5 | 1,422.7 | 981.1 | 69.9 | 58.1 | 35.6 | 1,144.7 |
| Interest rate contracts: | | | | | | | | | | |
| Interest rate swaps | 1,797.1 | 977.9 | 1,236.9 | 926.9 | 4,938.8 | 1,555.8 | 675.6 | 960.8 | 630.1 | 3,822.3 |
| Options purchased | 74.4 | 55.4 | 89.2 | 77.3 | 296.3 | 91.1 | 34.2 | 49.3 | 50.4 | 225.0 |
| Options written | 78.6 | 52.0 | 82.5 | 74.0 | 287.1 | 48.0 | 36.6 | 47.0 | 48.5 | 180.1 |
| Futures and forwards | 823.9 | 199.9 | 67.0 | | 1,090.8 | 865.3 | 159.3 | 55.3 | 0.5 | 1,080.4 |
| | 2,774.0 | 1,285.2 | 1,475.6 | 1,078.2 | 6,613.0 | 2,560.2 | 905.7 | 1,112.4 | 729.5 | 5,307.8 |
| Credit derivatives | 5.1 | 4.1 | 32.3 | 17.7 | 59.2 | 7.1 | 1.7 | 11.9 | 7.8 | 28.5 |
| Equity and commodity contracts | 24.3 | 7.5 | 11.4 | 0.2 | 43.4 | 20.4 | 5.3 | 8.2 | 0.2 | 34.1 |
| Non-trading derivatives | | | | | | | | | | |

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The Group establishes non-trading derivatives positions externally with third parties and also internally. It should be noted that the following tables include the components of the internal hedging programme that transfers risks to the trading portfolios in the Group or to external third party participants in the derivatives markets.

The following table summarises the fair values and book values of derivatives held for non-trading activities and includes internal trades:

| | 2004 | | 2004 | | 2003 | | 2003 | |
|---------------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| | Fair value | | Book value | | Fair value | | Book value | |
| | Positive £m | Negative £m | Positive £m | Negative £m | Positive £m | Negative £m | Positive £m | Negative £m |
| Exchange rate contracts: | | | | | | | | |
| Spot, forwards and futures | 46 | 665 | 35 | 603 | 101 | 464 | 94 | 460 |
| Currency swaps and options | 349 | 227 | 234 | 123 | 304 | 210 | 224 | 135 |
| | 395 | 892 | 269 | 726 | 405 | 674 | 318 | 595 |
| Interest rate contracts: | | | | | | | | |
| Interest rate swaps | 1,617 | 1,342 | 623 | 650 | 2,541 | 2,247 | 608 | 683 |
| Futures, forwards and options | 71 | 318 | 2 | 2 | 62 | 416 | 1 | 2 |
| | 1,688 | 1,660 | 625 | 652 | 2,603 | 2,663 | 609 | 685 |
| Credit derivatives | 4 | 11 | | 6 | 3 | 6 | | |
| Equity and commodity contracts | 207 | 62 | 102 | 15 | 118 | 52 | 78 | 22 |
| Total | 2,294 | 2,625 | 996 | 1,399 | 3,129 | 3,395 | 1,005 | 1,302 |

The following table analyses, by maturity and contract type, the notional principal amounts of the Group's non-trading derivatives (third party and internal):

| | Within | One to | Two to | Over | 2004 Total £bn | Within | One to | Two to | Over | 2003 Total £bn |
|---------------------------------|--------|--------|--------|-------|----------------------|--------|--------|--------|-------|----------------------|
| | one | two | five | five | | one | two | five | five | |
| | year | years | years | years | | year | years | years | years | |
| | £bn | £bn | £bn | £bn | £bn | £bn | £bn | £bn | £bn | £bn |
| Exchange rate contracts: | | | | | | | | | | |
| Spot, forwards and futures | 20.5 | 0.2 | | 0.1 | 20.8 | 19.4 | | 0.2 | 0.1 | 19.7 |
| Currency swaps and options | 1.6 | 0.3 | 1.1 | 2.0 | 5.0 | 3.2 | 1.0 | 0.7 | 1.9 | 6.8 |
| | 22.1 | 0.5 | 1.1 | 2.1 | 25.8 | 22.6 | 1.0 | 0.9 | 2.0 | 26.5 |
| Interest rate contracts: | | | | | | | | | | |
| Interest rate swaps | 34.4 | 6.7 | 30.7 | 48.7 | 120.5 | 34.4 | 15.1 | 33.5 | 43.7 | 126.7 |
| Futures, forwards and options | 0.9 | 0.2 | 3.8 | 8.7 | 13.6 | 0.4 | 0.1 | 3.3 | 4.6 | 8.4 |
| | 35.3 | 6.9 | 34.5 | 57.4 | 134.1 | 34.8 | 15.2 | 36.8 | 48.3 | 135.1 |

| | | | | | | | | | | |
|---------------------------------------|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|
| Credit derivatives | 0.1 | 0.3 | 0.8 | 1.2 | 0.5 | 0.2 | 0.3 | 1.0 | | |
| Equity and commodity contracts | 0.4 | 0.2 | 1.1 | 0.6 | 2.3 | 0.3 | 0.5 | 0.7 | 0.2 | 1.7 |

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40 Financial instruments

The Group's objectives and policies in managing the risks that arise in connection with the use of financial instruments are set out in the Operating and financial review under Market risk, Currency risk and Equity risk.

Interest rate sensitivity gap

The tables below summarise the Group's interest rate sensitivity gap for its non-trading book at 31 December 2004 and 31 December 2003. The tables show the contractual repricing for each category of asset, liability and for off-balance sheet items. A liability (or negative) gap position exists when liabilities reprice more quickly or in greater proportion than assets during a given period and tends to benefit net interest income in a declining interest rate environment. An asset (or positive) gap position exists when assets reprice more quickly or in greater proportion than liabilities during a given period and tends to benefit net interest income in a rising interest rate environment. Contractual repricing terms do not reflect the potential impact of early repayment or withdrawal. Positions may not be reflective of those in subsequent periods. Major changes in positions can be made promptly as market outlooks change. In addition, significant variations in interest rate sensitivity may exist within the re-pricing periods presented and among the currencies in which the Group has interest rate positions.

| | Within 3 months | | After 3 months but within 6 months | | After 6 months but within 1 year | | After 1 year but within 5 years | | After 5 years | | Non-interest bearing funds | Banking book total | Trading book total | Total |
|------------------------------------|-----------------|---------------|------------------------------------|---------------|----------------------------------|---------------|---------------------------------|----------------|----------------|----|----------------------------|--------------------|--------------------|-------|
| | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m | | | | |
| 2004 | | | | | | | | | | | | | | |
| Assets | | | | | | | | | | | | | | |
| Loans and advances to banks | 14,645 | 5,140 | 1,367 | 77 | 482 | 643 | 22,354 | 35,906 | 58,260 | | | | | |
| Loans and advances to customers | 189,366 | 16,202 | 11,379 | 35,370 | 28,612 | 2,304 | 283,233 | 62,236 | 345,469 | | | | | |
| Treasury bills and debt securities | 11,912 | 4,088 | 3,656 | 6,133 | 13,548 | 337 | 39,674 | 57,647 | 97,321 | | | | | |
| Other assets | | | | | | 57,508 | 57,508 | 24,909 | 82,417 | | | | | |
| Total assets | 215,923 | 25,430 | 16,402 | 41,580 | 42,642 | 60,792 | 402,769 | 180,698 | 583,467 | | | | | |
| Liabilities | | | | | | | | | | | | | | |
| Deposits by banks | 54,679 | 2,282 | 907 | 119 | 477 | 935 | 59,399 | 39,682 | 99,081 | | | | | |
| Customer accounts | 192,543 | 5,589 | 6,948 | 7,043 | 461 | 31,345 | 243,929 | 41,133 | 285,062 | | | | | |
| Debt securities in issue | 41,805 | 5,505 | 4,418 | 4,087 | 1,385 | | 57,200 | 1,760 | 58,960 | | | | | |

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| | | | | | | | | | |
|--|----------------|---------------|---------------|---------------|---------------|---------------|----------------|----------------|----------------|
| Subordinated liabilities | 4,401 | 1,020 | 302 | 2,151 | 12,438 | | 20,312 | 54 | 20,366 |
| Other liabilities | 4 | 5 | 8 | 49 | 126 | 34,948 | 35,140 | 52,993 | 88,133 |
| Shareholders funds | | | | | | 30,715 | 30,715 | 1,150 | 31,865 |
| Internal funding of trading book | (42,516) | (313) | (1,088) | (9) | | | (43,926) | 43,926 | |
| Total liabilities | 250,916 | 14,088 | 11,495 | 13,440 | 14,887 | 97,943 | 402,769 | 180,698 | 583,467 |
| Off-balance sheet items | (2,126) | (6,906) | (1,160) | 1,560 | 8,632 | | | | |
| Interest rate sensitivity gap | (37,119) | 4,436 | 3,747 | 29,700 | 36,387 | (37,151) | | | |
| Cumulative interest rate sensitivity gap | (37,119) | (32,683) | (28,936) | 764 | 37,151 | | | | |

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Notes on the accounts continued

40 Financial instruments (continued)

| | Within 3 months £m | After 3 months but within 6 months £m | After 6 months but within 1 year £m | After 1 year but within 5 years £m | After 5 years £m | Non-interest bearing funds £m | Banking book total £m | Trading book total £m | Total £m |
|------------------------------------|--------------------------|--|--|---|------------------------|--|--------------------------------|--------------------------------|----------------|
| Assets | | | | | | | | | |
| Loans and advances to banks | 11,149 | 3,780 | 5,188 | 122 | 32 | 1,087 | 21,358 | 30,533 | 51,891 |
| Loans and advances to customers | 155,920 | 11,832 | 7,763 | 27,992 | 18,463 | 1,486 | 223,456 | 29,075 | 252,531 |
| Treasury bills and debt securities | 18,906 | 2,594 | 4,835 | 5,525 | 11,175 | 2,316 | 45,351 | 39,444 | 84,795 |
| Other assets | | | | | | 46,583 | 46,583 | 18,628 | 65,211 |
| Total assets | 185,975 | 18,206 | 17,786 | 33,639 | 29,670 | 51,472 | 336,748 | 117,680 | 454,428 |
| Liabilities | | | | | | | | | |
| Deposits by banks | 37,670 | 1,178 | 408 | 308 | 414 | 1,083 | 41,061 | 26,262 | 67,323 |
| Customer accounts | 172,563 | 4,110 | 2,360 | 3,352 | 400 | 28,140 | 210,925 | 26,038 | 236,963 |
| Debt securities in issue | 27,254 | 2,567 | 4,428 | 4,804 | 846 | | 39,899 | 1,117 | 41,016 |
| Subordinated liabilities | 3,583 | 601 | 104 | 1,762 | 10,889 | | 16,939 | 59 | 16,998 |
| Other liabilities | 5 | 5 | 9 | 37 | 126 | 28,047 | 28,229 | 37,801 | 66,030 |

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| | | | | | | | | | |
|--|----------------|--------------|--------------|--------------|---------------|---------------|----------------|----------------|----------------|
| Shareholders funds | | | | | | 25,017 | 25,017 | 1,081 | 26,098 |
| Internal funding of trading business | (22,447) | (1,060) | (1,239) | (379) | (197) | | (25,322) | 25,322 | |
| Total liabilities | 218,628 | 7,401 | 6,070 | 9,884 | 12,478 | 82,287 | 336,748 | 117,680 | 454,428 |
| Off-balance sheet items | (7,943) | (1,122) | 3,597 | 964 | 4,504 | | | | |
| Interest rate sensitivity gap | (40,596) | 9,683 | 15,313 | 24,719 | 21,696 | (30,815) | | | |
| Cumulative interest rate sensitivity gap | (40,596) | (30,913) | (15,600) | 9,119 | 30,815 | | | | |

*restated (see page 85)

Currency risk

The Group does not maintain material non-trading open currency positions other than the structural foreign currency translation exposures arising from its investment in overseas subsidiary and associated undertakings and their related funding.

The Group's structural currency exposures were as follows:

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

Trading book market risk

An explanation of the value-at-risk (VaR) methodology of estimating potential losses arising from the Group's exposure to market risk in its trading book and the main assumptions and parameters underlying it is given in Risk management market risk in the Operating and financial review.

The following table analyses the VaR for the Group's trading portfolios by type of market risk exposure at the period end and as an average for the period and the maximum and minimum for the period:

| | Year ended 31 December 2004 | | | | Year ended 31 December 2003 | | | |
|-------------------------|-----------------------------|---------|---------|---------|-----------------------------|---------|---------|---------|
| | 31 December 2004 | Maximum | Minimum | Average | 31 December 2003 | Maximum | Minimum | Average |
| | £m | £m | £m | £m | £m | £m | £m | £m |
| Interest rate | 11.2 | 16.5 | 6.9 | 11.5 | 7.4 | 14.5 | 5.7 | 9.4 |
| Currency | 1.2 | 2.7 | 0.5 | 1.1 | 0.8 | 2.5 | 0.7 | 1.3 |
| Equity | 0.2 | 2.0 | 0.2 | 0.6 | 0.4 | 1.4 | 0.2 | 0.5 |
| Diversification effects | (2.3) | | | | (1.2) | | | |

| | | | | | | | | |
|-------|------|------|-----|------|-----|------|-----|-----|
| Total | 10.3 | 16.0 | 6.4 | 10.8 | 7.4 | 14.2 | 5.6 | 9.4 |
|-------|------|------|-----|------|-----|------|-----|-----|

Fair values of financial instruments

The following tables set out the fair values of the Group's financial instruments. Fair value is the amount at which an instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. 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 judgements covering prepayments, credit risk and discount rates. Changes in these assumptions would significantly affect estimated fair values. The fair values reported would not necessarily be realised in an immediate sale; nor are there plans to settle liabilities prior to contractual maturity. As there is a wide range of valuation techniques, it may be inappropriate to compare the Group's fair value information to independent markets or other financial institutions' fair value.

| | Note | 2004 Carrying amount £m | 2004 Fair value £m | 2003 Carrying amount £m | 2003 Fair value £m |
|---|------|----------------------------------|-----------------------------|----------------------------------|-----------------------------|
| Trading business | | | | | |
| Assets | | | | | |
| Treasury bills and other eligible bills | (1) | 2,921 | 2,921 | 1,869 | 1,869 |
| Loans and advances to banks and customers | (1) | 98,142 | 98,142 | 59,608 | 59,608 |
| Debt securities | (1) | 54,726 | 54,726 | 37,575 | 37,575 |
| Equity shares | (1) | 486 | 486 | 428 | 428 |
| Derivatives | (2) | 17,884 | 17,884 | 14,087 | 14,087 |

Liabilities

| | | | | | |
|---|-----|--------|--------|--------|--------|
| Deposits by banks and customer accounts | (3) | 80,815 | 80,815 | 52,300 | 52,300 |
| Debt securities in issue | (1) | 1,760 | 1,760 | 1,117 | 1,117 |
| Short positions in securities | (1) | 28,923 | 28,923 | 19,128 | 19,128 |
| Subordinated loan capital | (1) | 54 | 54 | 59 | 59 |
| Derivatives | (2) | 19,034 | 19,034 | 15,173 | 15,173 |

| | Note | 2004 Carrying amount £m | 2004 Fair value £m | 2003 Carrying amount £m | 2003 Fair value £m |
|------------------------------------|------|----------------------------------|-----------------------------|----------------------------------|-----------------------------|
| Banking business | | | | | |
| Assets | | | | | |
| Cash and balances at central banks | (1) | 4,293 | 4,293 | 3,822 | 3,822 |

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| | | | | | |
|--|-----|---------|---------|---------|---------|
| Items in the course of collection from other banks | (1) | 2,629 | 2,629 | 2,501 | 2,501 |
| Treasury bills and other eligible bills | (1) | 3,189 | 3,189 | 2,977 | 2,977 |
| Loans and advances to banks and customers | (4) | 305,587 | 307,805 | 244,814 | 246,244 |
| Debt securities | (5) | 36,485 | 36,299 | 42,374 | 42,195 |
| Equity shares | (5) | 2,474 | 2,916 | 1,872 | 2,289 |

Liabilities

| | | | | | |
|--|-----|---------|---------|---------|---------|
| Items in the course of transmission to other banks | (1) | 802 | 802 | 958 | 958 |
| Deposits by banks and customer accounts | (3) | 303,328 | 303,210 | 251,986 | 252,360 |
| Debt securities in issue | (6) | 57,200 | 57,199 | 39,899 | 39,897 |
| Subordinated loan capital | (7) | 20,312 | 21,652 | 16,939 | 17,522 |
| Non-equity minority interests | (7) | 3,671 | 3,899 | 2,724 | 2,867 |
| Non-equity shareholders funds | (7) | 4,520 | 4,811 | 2,923 | 3,245 |
| Derivatives net | (2) | 403 | 331 | 297 | 266 |

Notes:

- (1) Financial assets and financial liabilities carried at fair value or where carrying value approximates to fair value because they are of short maturity or repricing date.
- (2) Fair values of derivatives are determined by market prices where available. Otherwise fair value is based on current market information using appropriate valuation models.
- (3) The fair value of deposits repayable on demand is equal to their carrying value. The fair values of term deposits and time certificates of deposit are estimated by discounting expected future cash flows using rates currently offered for deposits of similar remaining maturities.
- (4) For loans which reprice frequently or are linked to the Group's base rate, and for which there has been no significant change in credit risk since inception, carrying value represents a reasonable estimate of fair value. For other loans, fair values are estimated by discounting expected future cash flows, using current interest rates appropriate to the type of loan, and making adjustments for credit risk.
- (5) Fair values of marketable securities are based on quoted market prices. Where these are unavailable, fair value is estimated using other valuation techniques.
- (6) The fair value of short-term debt securities in issue is approximately equal to their carrying value. The fair value of other debt securities in issue is based on quoted market prices where available, or where these are unavailable, is estimated using other valuation techniques.
- (7) The fair value of loan capital, non-equity minority interests and preference shares is based on quoted market prices where available. For unquoted loan capital, fair value has been estimated using other valuation techniques.
- (8) Fair values are not given for financial commitments and contingent liabilities. The diversity of the fee structures, the lack of an established market and the difficulty of separating the value of the instruments from the value of the overall relationship involve such uncertainty that it is not meaningful to provide an estimate of their fair value. (The principal amounts of these instruments are given in Note 41).

Notes on the accounts continued

40 Financial instruments (continued)

Hedges

Derivatives and debt securities held for hedging purposes are accounted for in accordance with the treatment of the hedged transaction. As a result, any gains or losses on the hedging instrument arising from changes in fair values are not recognised in the profit and loss account immediately but are accounted for in the same manner as the hedged item.

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| | 2004 Unrecognised gains and losses £m | 2004 Deferred gains and losses £m | 2003 Unrecognised gains and losses £m |
|--|---|---|---|
| At 1 January gains losses | 2,236 (2,205) | 213 (34) | 2,535 (2,275) |
| Recognised gains that arose in previous periods | 31 (781) | 179 (65) | 260 (659) |
| Recognised losses that arose in previous periods | 537 | 4 | 636 |
| Unrecognised gains and losses arising in the year | 224 | | (208) |
| Unrecognised gains and losses deferred in the year | 61 | (61) | 2 |
| Unrecognised gains and losses deferred and taken to profit and loss in the year | | (30) | |
| At 31 December | 72 | 27 | 31 |
| Of which gains losses | 1,571 (1,499) | 483 (456) | 2,236 (2,205) |
| | 72 | 27 | 31 |
| Gains expected to be recognised in the year to 31 December 2005 (year to 31 December 2004) | 318 | 171 | 532 |
| Gains expected to be recognised in the year to 31 December 2006 or later (year to 31 December 2005 or later) | 1,253 | 312 | 1,704 |
| | 1,571 | 483 | 2,236 |
| Losses expected to be recognised in the year to 31 December 2005 (year to 31 December 2004) | (221) | (91) | (371) |
| Losses expected to be recognised in the year to 31 December 2006 or later (year to 31 December 2005 or later) | (1,278) | (365) | (1,834) |
| | (1,499) | (456) | (2,205) |

During the year to 31 December 2004, gains of £249 million (2003 £58 million) and losses of £166 million (2003 £95 million) arising in previous periods were taken directly to the profit and loss account on financial instruments no longer accounted for as hedges.

41 Memorandum items

Contingent liabilities and commitments

The amounts shown in the table below are intended only to provide an indication of the volume of business outstanding at 31 December. Although the Group is exposed to credit risk in the event of non-performance of the obligations undertaken by customers, the amounts shown do not, and are not intended to, provide any indication of the Group's expectation of future losses.

| | 2004 £m | 2003 £m |
|--|------------|------------|
| | | |

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| | | |
|---|---------|---------|
| Contingent liabilities: | | |
| Acceptances and endorsements | 362 | 595 |
| Guarantees and assets pledged as collateral security | 10,438 | 8,787 |
| Other contingent liabilities | 5,293 | 5,482 |
| | <hr/> | |
| | 16,093 | 14,864 |
| | <hr/> | |
| Commitments: | | |
| Documentary credits and other short-term trade related transactions | 182 | 605 |
| Undrawn formal standby facilities, credit lines and other commitments to lend | | |
| less than one year | 109,653 | 85,424 |
| one year and over | 69,577 | 51,827 |
| Other commitments | 1,365 | 1,837 |
| | <hr/> | |
| | 180,777 | 139,693 |
| | <hr/> | |

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Banking commitments and contingent obligations, which have been entered into on behalf of customers and for which there are corresponding obligations from customers, are not included in assets and liabilities. The Group's maximum exposure to credit loss, in the event of non-performance by the other party and where all counterclaims, collateral or security proves valueless, is represented by the contractual nominal amount of these instruments included in the table. These commitments and contingent obligations are subject to the Group's normal credit approval processes and any potential loss is taken into account in assessing provisions for bad and doubtful debts in accordance with the Group's provisioning policy.

Contingent liabilities

Acceptances in accepting a bill of exchange drawn on it by a customer a bank undertakes to pay the holder of the bill at maturity. Most acceptances are presented for payment and reimbursement by the customer is usually immediate. In the UK, bills accepted by certain banks designated by the Bank of England are eligible for rediscount at the Bank of England.

Endorsements in endorsing a bill of exchange a bank accepts liability for payment of any shortfall on the bill at maturity. Unlike acceptances, the endorsing bank receives value for the bill, which is then rediscounted.

Guarantees the Group gives guarantees on behalf of customers. A financial guarantee represents an irrevocable undertaking that the Group will meet a customer's obligations to third parties if the customer fails to do so. The maximum amount that the Group could be required to pay under a guarantee is its principal amount as disclosed in the table above. The Group expects most guarantees it provides to expire unused.

Other contingent liabilities these include standby letters of credit, supporting customer debt issues and contingent liabilities relating to customer trading activities such as those arising from performance and customs bonds, warranties and indemnities.

Commitments

Documentary credits and other short-term trade related transactions documentary letters are commercial letters of credit providing for payment by the Group to a named beneficiary against presentation of specified documents.

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Commitments to lend under a loan commitment the Group agrees to make funds available to a customer in the future. Loan commitments, which are usually for a specified term may be unconditionally cancellable or may persist, provided all conditions in the loan facility are satisfied or waived. Commitments to lend include commercial standby facilities and credit lines, liquidity facilities to commercial paper conduits and unutilised overdraft facilities.

Other commitments these include forward asset purchases, forward deposits placed and undrawn note issuance and revolving underwriting facilities.

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

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

Litigation

Since December 2003, members of the Group have been joined as defendants in a number of legal actions in the United States following the collapse of Enron. Collectively, the claims are, to a substantial degree, unquantified and in each case they are made against large numbers of defendants. The Group intends to defend these claims vigorously. The US Courts dealing with the main Enron actions have ordered that the Group join the non-binding, multi-party mediation which commenced in late 2003. Based on current knowledge including applicable defences and given the unquantified nature of these claims, the directors are unable at this stage to predict with certainty the eventual loss in these matters. In addition, pursuant to requests received from the US Securities and Exchange Commission and the US Department of Justice, the Group has been providing copies of Enron-related materials to these authorities and the Group continues to cooperate fully with them.

Members of the Group are engaged in other litigation in the United Kingdom and a number of overseas jurisdictions, including the United States, involving claims by and against them arising in the ordinary course of business. The directors of the company have reviewed these other actual, threatened and known potential claims and proceedings and, after consulting with the Group's legal advisers are satisfied that the outcome of these claims and proceedings will not have a material adverse effect on the Group's consolidated net assets, results of operations or cash flows.

Notes on the accounts continued

42 Acquisitions

The Group made a number of acquisitions during the year, all of which were accounted for using acquisition accounting principles.

(a) Charter One

Charter One Financial, Inc. was acquired by Citizens in August 2004 for a cash consideration of US\$10.1 billion. The acquisition has extended Citizen's coverage to North Eastern and Mid Western States of the US and will enable Citizens to achieve a significant increase in the scale of its activities.

Although not required, as it is not a material acquisition for the Group, separate purchase accounting disclosures for Charter One Financial, Inc. are set out below. The provisional fair values of the assets and liabilities acquired and the consideration paid are shown in the table below:

| At date of acquisition | Book value of net assets | Fair value adjustments | Fair value to the Group |
|------------------------|-----------------------------|---------------------------|----------------------------|
|------------------------|-----------------------------|---------------------------|----------------------------|

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| | acquired £m | £m | £m |
|---|----------------|-------|----------|
| Cash and balances at central banks | 330* | | 330 |
| Loans and advances to customers | 18,287 | (274) | 18,013 |
| Debt securities | 3,107 | (26) | 3,081 |
| Equity shares | 381 | | 381 |
| Tangible fixed assets | 699 | | 699 |
| Other assets | 740 | (2) | 738 |
| Deposits by banks | (5,579) | | (5,579) |
| Customer accounts | (15,823) | (28) | (15,851) |
| Other liabilities | (49) | (45) | (94) |
| Deferred tax provisions | (534) | 46 | (488) |
| Post-retirement pension liabilities | (17) | | (17) |
| Dated loan capital | (222) | (22) | (244) |
| Net assets acquired | 1,320* | (351) | 969 |
| Goodwill | | | 4,654 |
| Total consideration | | | 5,623 |
| Satisfied by: | | | |
| Payment of cash | | | 5,611 |
| Fees and expenses relating to the acquisition | | | 12 |
| | | | 5,623 |

* Reduced by £307 million (US\$553 million) paid out by Charter One immediately prior to closing principally in respect of the buyout of employee stock options. Gross of this amount, consideration was £5,930 million (US\$10,677 million) and the book value of net assets acquired £1,627 million (US\$2,929 million).

Fair value adjustments reflect the restatement of balances to their estimated fair values at the date of acquisition, and the related tax effect.

The estimated contribution to the Group's results, before funding costs of Charter One, for the year ended 31 December 2004 is shown below:

| | Four months ended 31 December 2004 £m |
|---|---|
| Net interest income | 220 |
| Non-interest income | 129 |
| Total income | 349 |
| Operating expenses | (177) |
| Contribution before provisions | 172 |
| Provisions | (16) |
| Contribution before goodwill amortisation | 156 |
| Goodwill amortisation | (76) |
| Contribution | 80 |

The contribution above is after charging goodwill amortisation and includes the post-acquisition effect of fair value adjustments.

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(b) Other acquisitions

The provisional fair values of the assets and liabilities of all other acquisitions made during the year and the consideration paid are shown in the table below:

| At respective dates of acquisition | Book value of net assets acquired £m | Fair value adjustments £m | Fair value to the Group £m |
|--|---|---------------------------------|----------------------------------|
| Cash and balances at central banks | 106 | 2 | 108 |
| Loans and advances to banks | 768 | | 768 |
| Loans and advances to customers | 5,491 | (70) | 5,421 |
| Debt securities | 938 | (6) | 932 |
| Tangible fixed assets | 106 | (7) | 99 |
| Other assets | 129 | (15) | 114 |
| Prepayments and accrued income | 5 | 5 | 10 |
| Deposits by banks | (1,874) | | (1,874) |
| Customer accounts | (3,208) | (4) | (3,212) |
| Debt securities in issue | (777) | | (777) |
| Other liabilities | (118) | 45 | (73) |
| Accruals and deferred income | (27) | (38) | (65) |
| Deferred tax provisions | (6) | (20) | (26) |
| Post-retirement benefit liabilities | (15) | | (15) |
| Other provisions | (13) | 1 | (12) |
| Dated loan capital | (81) | (7) | (88) |
| Undated loan capital | (36) | (29) | (65) |
| Minority interest-equity | (4) | | (4) |
| Net assets acquired | 1,384 | (143) | 1,241 |
| Goodwill | | | 1,245 |
| Total consideration | | | 2,486 |
| Satisfied by: | | | |
| Payment of cash | | | 2,468 |
| Loan notes | | | 4 |
| Fees and expenses relating to the acquisitions | | | 14 |
| | | | 2,486 |

Fair value adjustments reflect the restatement of balances to their estimated fair values at the date of acquisition, and the related tax effect.

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The estimated contribution to the Group's results, before funding costs of the acquisitions, is shown below:

| | Year ended 31 December 2004* £m |
|--|---------------------------------------|
| Net interest income | 165 |
| Non-interest income | 88 |
| Total income | 253 |
| Operating expenses | (125) |
| Operating profit | 128 |
| Provisions | (42) |
| Contribution before goodwill amortisation | 86 |
| Goodwill amortisation | (45) |
| Contribution | 41 |

* From the dates of acquisition. The contribution above is after charging goodwill amortisation and includes the post-acquisition effect of fair value adjustments.

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Notes on the accounts continued

43 Reconciliation of operating profit to net cash inflow from operating activities

| | 2004 | 2003* | 2002* |
|---|---------|---------|-------|
| | £m | £m | £m |
| Operating profit | 6,917 | 6,076 | 4,852 |
| Increase in prepayments and accrued income | (1,609) | (514) | (636) |
| Interest on subordinated liabilities | 681 | 551 | 659 |
| Increase in accruals and deferred income | 2,300 | 1,455 | 872 |
| Amortisation of and provisions against investment securities | 92 | 60 | 99 |
| Provisions for bad and doubtful debts | 1,428 | 1,461 | 1,286 |
| Loans and advances written off net of recoveries | (1,321) | (1,447) | (973) |
| Profit on sale of tangible fixed assets | (69) | (30) | (32) |
| Profit on sale of subsidiaries and associates | (4) | (63) | (13) |
| Profit from associated undertakings | (35) | (12) | (2) |
| Profit on sale of investment securities | (167) | (172) | (85) |
| Charge for pensions | 381 | 330 | 127 |
| Pension contributions | (1,146) | (141) | (168) |
| Provisions for liabilities and charges | 20 | 36 | 47 |
| Provisions utilised | (47) | (99) | (56) |
| Depreciation and amortisation of tangible and intangible fixed assets | 2,022 | 1,682 | 1,626 |
| Increase in value of long-term assurance business | (94) | (73) | (61) |

| | | | |
|---|--------------|---------------|---------------|
| Net cash inflow from trading activities | 9,349 | 9,100 | 7,542 |
| (Increase)/decrease in items in the course of collection | (128) | 240 | 547 |
| (Increase)/decrease in treasury and other eligible bills | (1,264) | 6,626 | (1,323) |
| (Increase)/decrease in loans and advances to banks | (3,370) | 2,797 | (2,756) |
| Increase in loans and advances to customers | (69,543) | (26,140) | (32,670) |
| (Increase)/decrease in securities | (10,367) | (9,871) | 1,799 |
| Increase in other assets | (3,503) | (977) | (1,181) |
| Decrease in items in the course of transmission | (156) | (300) | (851) |
| Increase in deposits by banks | 24,310 | 11,188 | 14,512 |
| Increase in customer accounts | 29,107 | 15,669 | 19,383 |
| Increase in debt securities in issue | 17,163 | 7,078 | 3,269 |
| Increase/(decrease) in other liabilities | 4,817 | (168) | 3,817 |
| Increase in settlement balances and short positions | 8,796 | 3,202 | 482 |
| Effect of other accruals/deferrals and other non-cash movements | 1,096 | 1,264 | 1,167 |
| Net cash inflow from operating activities | 6,307 | 19,708 | 13,737 |

* restated (see page 85)

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44 Analysis of the net outflow of cash in respect of the purchase of businesses and subsidiary undertakings

| | 2004 £m | 2003 £m | 2002 £m |
|----------------------------|----------------|----------------|--------------|
| Cash consideration paid | (8,105) | (2,252) | (415) |
| Cash acquired | 457 | 504 | 107 |
| Net outflow of cash | (7,648) | (1,748) | (308) |

45 Sale of subsidiary and associated undertakings

| | 2004 £m | 2003 £m | 2002 £m |
|---|------------|------------|------------|
| Net assets disposed of | 2 | 66 | 13 |
| Goodwill written back | | 40 | |
| Goodwill sold | 16 | 10 | 3 |
| Profit on disposal | 4 | 63 | 13 |
| Net inflow of cash in respect of disposals (net of expenses) | 22 | 179 | 29 |

46 Analysis of changes in financing during the year

| Share capital (including share premium) | Loan capital |
|--|--------------|
|--|--------------|

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| | 2004 £m | 2003 £m | 2002 £m | 2004 £m | 2003 £m | 2002 £m |
|--|------------|------------|------------|------------|------------|------------|
| At 1 January | 8,944 | 8,362 | 8,358 | 16,998 | 13,965 | 12,530 |
| Currency translation adjustments | (231) | (203) | (283) | (475) | (448) | (520) |
| Net cash inflow/(outflow) from financing | 4,203 | (180) | (515) | 3,906 | 3,481 | 1,955 |
| Acquisition of subsidiaries | | | | 397 | | |
| Other non-cash movements | 870 | 965 | 802 | (460) | | |
| At 31 December | 13,786 | 8,944 | 8,362 | 20,366 | 16,998 | 13,965 |

47 Analysis of cash

| | 2004 £m | 2003 £m | 2002 £m |
|---|------------|------------|------------|
| Cash and balances at central banks | 4,293 | 3,822 | 3,481 |
| Loans and advances to banks repayable on demand | 19,430 | 17,115 | 6,792 |
| Cash | 23,723 | 20,937 | 10,273 |

Certain subsidiary undertakings are required to maintain balances with the Bank of England which, at 31 December 2004, amounted to £260 million (2003 £231 million). Certain subsidiary undertakings are required by law to maintain reserve balances with the Federal Reserve Bank in the US. Such reserve balances amounted to US\$132 million at 31 December 2004 (2003 US\$190 million).

48 Analysis of changes in cash during the year

| | 2004 £m | 2003 £m | 2002 £m |
|-----------------|------------|------------|------------|
| At 1 January | 20,937 | 10,273 | 7,027 |
| Net cash inflow | 2,786 | 10,664 | 3,246 |
| At 31 December | 23,723 | 20,937 | 10,273 |

Notes on the accounts continued

49 Segmental analysis

In the tables below, the analyses of net assets are included in compliance with Statement of Standard Accounting Practice 25 Segmental Reporting. The fungible nature of liabilities within the banking industry results in allocations of liabilities which, in some cases, are necessarily subjective. The directors believe that it is more meaningful to analyse total assets and the result of this analysis is therefore also included in the tables.

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The prior year data in the tables below have been restated to reflect the transfer in 2004 of certain activities from Wealth Management to Retail Banking and from other divisions, principally RBS Insurance and Ulster Bank, to Manufacturing.

a) Classes of business

| | Net interest income £m | Non-interest income £m | Total income £m | Operating expenses and other operating charges £m | Provisions* | Profit/ (loss) on ordinary activities before tax £m |
|---|---------------------------------|------------------------------|-----------------------|--|-------------|--|
| 2004 | | | | | | |
| Corporate Banking and Financial Markets | 2,545 | 4,964 | 7,509 | (2,664) | (580) | 4,265 |
| Retail Banking | 3,112 | 1,630 | 4,742 | (1,074) | (389) | 3,279 |
| Retail Direct | 938 | 1,191 | 2,129 | (712) | (377) | 1,040 |
| Manufacturing Wealth Management | 497 | 451 | 948 | (2,439) | (17) | (2,439) |
| RBS Insurance | 420 | 4,514 | 4,934 | (463) | | 862 |
| Ulster Bank | 550 | 193 | 743 | (4,072) | (40) | 468 |
| Citizens | 1,540 | 601 | 2,141 | (235) | (80) | 1,037 |
| Central items | (394) | 2 | (392) | (1,024) | (28) | (879) |
| Profit before goodwill amortisation and integration costs | 9,208 | 13,546 | 22,754 | (13,142) | (1,511) | 8,101 |
| Goodwill amortisation | | | | (915) | | (915) |
| Integration costs | | | | (269) | | (269) |
| Profit on ordinary activities before tax | 9,208 | 13,546 | 22,754 | (14,326) | (1,511) | 6,917 |

2003

| | | | | | | |
|--|-------|-------|-------|---------|-------|---------|
| Corporate Banking and Financial Markets | 2,324 | 4,373 | 6,697 | (2,322) | (755) | 3,620 |
| Retail Banking | 2,959 | 1,514 | 4,473 | (1,030) | (273) | 3,170 |
| Retail Direct | 849 | 986 | 1,835 | (657) | (297) | 881 |
| Manufacturing Wealth Management | 457 | 352 | 809 | (2,114) | (9) | (2,114) |
| RBS Insurance | 232 | 3,013 | 3,245 | (398) | | 609 |
| Ulster Bank | 396 | 185 | 581 | (2,636) | (32) | 354 |
| Citizens | 1,310 | 514 | 1,824 | (195) | (88) | 857 |

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| | | | | | | |
|---|-------|--------|--------|----------|---------|-------|
| Central items** | (226) | 43 | (183) | (488) | (40) | (711) |
| Profit before goodwill amortisation and integration costs | 8,301 | 10,980 | 19,281 | (10,719) | (1,494) | 7,068 |
| Goodwill amortisation | | | | (763) | | (763) |
| Integration costs | | | | (229) | | (229) |
| Profit on ordinary activities before tax | 8,301 | 10,980 | 19,281 | (11,711) | (1,494) | 6,076 |

2002

| | | | | | | |
|---|-------|-------|--------|----------|---------|-------|
| Corporate Banking and Financial Markets | 2,349 | 3,703 | 6,052 | (2,066) | (725) | 3,261 |
| Retail Banking | 2,849 | 1,430 | 4,279 | (992) | (213) | 3,074 |
| Retail Direct | 749 | 841 | 1,590 | (601) | (281) | 708 |
| Manufacturing Wealth Management | 451 | 370 | 821 | (425) | 11 | 407 |
| RBS Insurance | 158 | 1,981 | 2,139 | (1,683) | | 456 |
| Ulster Bank | 339 | 181 | 520 | (180) | (22) | 318 |
| Citizens | 1,248 | 468 | 1,716 | (855) | (95) | 766 |
| Central items** | (294) | 193 | (101) | (377) | (20) | (498) |
| Profit before goodwill amortisation and integration costs | 7,849 | 9,167 | 17,016 | (9,131) | (1,345) | 6,540 |
| Goodwill amortisation | | | | (731) | | (731) |
| Integration costs | | | | (957) | | (957) |
| Profit on ordinary activities before tax | 7,849 | 9,167 | 17,016 | (10,819) | (1,345) | 4,852 |

* comprises provisions for bad and doubtful debts and amounts written off fixed asset investments.

** restated (see page 85)

| | Total assets | | Net assets | |
|---|--------------|-------------|------------|-------------|
| | 2004 £m | 2003* £m | 2004 £m | 2003* £m |
| Corporate Banking and Financial Markets | 346,823 | 268,523 | 13,035 | 11,726 |
| Retail Banking | 77,900 | 67,360 | 4,269 | 3,747 |
| Retail Direct | 26,862 | 21,905 | 1,479 | 1,236 |
| Manufacturing | 5,174 | 4,259 | 242 | 194 |
| Wealth Management | 11,751 | 15,211 | 580 | 669 |
| RBS Insurance | 10,822 | 10,124 | 1,829 | 1,362 |
| Ulster Bank | 27,365 | 15,560 | 1,385 | 988 |
| Citizens | 68,262 | 42,897 | 10,042 | 4,395 |
| Central items | 8,508 | 8,589 | (996) | 1,781 |
| | 583,467 | 454,428 | 31,865 | 26,098 |

* restated (see page 85)

Segmental analysis of goodwill is as follows:

| | CBFM £m | Retail Banking £m | Retail Direct £m | Wealth Management £m | RBS Insurance £m | Ulster Bank £m | Citizens £m | Central items £m |
|--|------------|-------------------------|------------------------|----------------------------|------------------------|----------------------|----------------|------------------------|
| Cost: | | | | | | | | |
| At 1 January 2004 | 191 | | 114 | 153 | 1,011 | | 2,668 | 11,600 |
| Currency translation and other adjustments | | | (31) | 1 | | 1 | (529) | |
| Arising on acquisitions during the year | 9 | 98 | 592 | | 19 | 478 | 4,703 | |
| Disposals | | | | | | | (20) | |
| At 31 December 2004 | 200 | 98 | 675 | 154 | 1,030 | 479 | 6,822 | 11,600 |
| Amortisation: | | | | | | | | |
| At 1 January 2004 | 14 | | 6 | 1 | 69 | | 331 | 2,200 |
| Currency translation and other adjustments | | | (1) | | | 1 | (35) | |
| Charge for the year | 12 | 2 | 23 | 8 | 57 | 23 | 209 | 500 |
| Disposals | | | | | | | (4) | |
| At 31 December 2004 | 26 | 2 | 28 | 9 | 126 | 24 | 501 | 2,700 |
| Net book value: | | | | | | | | |
| At 31 December 2004 | 174 | 96 | 647 | 145 | 904 | 455 | 6,321 | 8,900 |

At 31 December 2003

177

108

152

942

2,337

9,4

(b) Geographical segments

The geographical analyses in the tables below have been compiled on the basis of location of office where the transactions are recorded.

| 2004 | UK £m | USA £m | Europe £m | Rest of the World £m | Total £m |
|---|----------|-----------|--------------|-------------------------------|-------------|
| Interest receivable | 12,469 | 2,763 | 1,267 | 197 | 16,696 |
| Dividend income | 42 | 17 | 20 | | 79 |
| Fees and commissions receivable | 5,260 | 808 | 467 | 99 | 6,634 |
| Dealing profits | 1,113 | 821 | 18 | 36 | 1,988 |
| Other operating income | 1,504 | 92 | 255 | 4 | 1,855 |
| General insurance premium income (net of reinsurance) | 4,794 | | 150 | | 4,944 |
| Gross income | 25,182 | 4,501 | 2,177 | 336 | 32,196 |
| Profit on ordinary activities before tax | 4,776 | 1,389 | 625 | 127 | 6,917 |
| Total assets | 378,396 | 145,572 | 45,593 | 13,906 | 583,467 |
| Net assets | 18,070 | 11,068 | 2,671 | 56 | 31,865 |

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Notes on the accounts continued**49 Segmental analysis** (continued)

| 2003* | UK £m | USA £m | Europe £m | Rest of the World £m | Total £m |
|-------|----------|-----------|--------------|-------------------------------|-------------|
|-------|----------|-----------|--------------|-------------------------------|-------------|

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| | | | | | |
|---|----------------|----------------|---------------|--------------|----------------|
| Interest receivable | 10,780 | 2,142 | 942 | 134 | 13,998 |
| Dividend income | 33 | 7 | 18 | | 58 |
| Fees and commissions receivable | 4,663 | 622 | 323 | 85 | 5,693 |
| Dealing profits | 1,004 | 717 | 39 | 33 | 1,793 |
| Other operating income | 1,432 | 86 | 132 | | 1,650 |
| General insurance premium income (net of reinsurance) | 2,981 | | 142 | | 3,123 |
| Gross income | 20,893 | 3,574 | 1,596 | 252 | 26,315 |
| Profit on ordinary activities before tax | 4,456 | 1,159 | 315 | 146 | 6,076 |
| Total assets | 314,638 | 102,389 | 27,411 | 9,990 | 454,428 |
| Net assets | 18,669 | 5,364 | 2,060 | 5 | 26,098 |

2002*

| | | | | | |
|--|----------------|----------------|---------------|--------------|----------------|
| Interest receivable | 10,372 | 2,240 | 837 | 112 | 13,561 |
| Dividend income | 32 | 10 | 16 | | 58 |
| Fees and commissions receivable | 4,375 | 601 | 251 | 22 | 5,249 |
| Dealing profits | 736 | 649 | 42 | 35 | 1,462 |
| Other operating income | 1,346 | 32 | 40 | (8) | 1,410 |
| General insurance premium income (net of reinsurance) | 1,874 | | 79 | | 1,953 |
| Gross income | 18,735 | 3,532 | 1,265 | 161 | 23,693 |
| Profit/(loss) on ordinary activities before tax | 3,928 | 618 | 340 | (34) | 4,852 |
| Total assets | 279,478 | 102,532 | 25,354 | 3,674 | 411,038 |
| Net assets | 19,098 | 4,056 | 1,917 | | 25,071 |

* restated (see page 85)

50 Directors remuneration

| | 2004 | 2003 |
|---|-------|-------|
| | £000 | £000 |
| Non-executive directors' emoluments | 874 | 759 |
| Chairman and executive directors' emoluments | 8,421 | 7,945 |
| contributions and allowances in respect of defined contribution pension schemes | 178 | 164 |

| | | |
|--|--------|--------|
| | 9,473 | 8,868 |
| amounts receivable under long-term incentive plans | 2,189 | 6,056 |
| gains on exercise of share options | 5 | 2 |
| | 11,667 | 14,926 |

Retirement benefits are accruing to five directors (2003 six) under defined benefit schemes, two (2003 two) of whom also accrued benefits under defined contribution schemes.

The executive directors may also participate in the company's executive share option, sharesave and option 2000 schemes and details of their interests in the company's shares arising from their participation are contained on page 77. Details of the remuneration received by each director during the year and each directors' pension arrangements are given on pages 76 to 79.

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51 Transactions with directors, officers and others

(a) At 31 December 2004, the amounts outstanding in relation to transactions, arrangements and agreements entered into by authorised institutions in the Group were £234,265 in respect of loans to eight persons who were directors of the company (or persons connected with them) at any time during the financial period and £30,926 to one person who was an officer of the company at any time during the financial period.

(b) There were no contracts of significance to the business of the company and its subsidiaries which subsisted at 31 December 2004, or during the year then ended, in which any director of the company had a material interest.

52 Related party transactions

Subsidiary undertakings

In accordance with Financial Reporting Standard 8 Related Party Disclosures (FRS 8), transactions or balances between Group entities that have been eliminated on consolidation are not reported.

Investments

Group members provide development and other types of capital support to businesses in their roles as providers of finance. These investments are made in the normal course of business and on arm's-length terms depending on their nature. In some instances, the investment may extend to ownership or control over 20% or more of the voting rights of the investee company. However, these investments are not considered to give rise to transactions of a materiality requiring disclosure under FRS 8.

Pension Fund

The Group recharges The Royal Bank of Scotland Group Pension Fund with the cost of administration services incurred by it. The amounts involved are not material to the Group.

53 Significant differences between UK and US generally accepted accounting principles

The consolidated financial statements of the Group are prepared in accordance with UK generally accepted accounting principles (GAAP) that differ in certain material respects from US GAAP. The significant differences are summarised as follows:

(a) Acquisition accounting

Under UK GAAP, all integration costs relating to acquisitions are expensed as post-acquisition expenses. Under US GAAP, certain restructuring and exit costs incurred in the acquired business are treated as liabilities assumed on acquisition and taken into account in the calculation of goodwill.

Under UK GAAP, provisional fair value adjustments made in the accounting year in which the acquisition occurs may be amended in the subsequent accounting year. Under US GAAP, the allocation of the cost of acquisition to the fair values of assets and liabilities is generally completed within 12 months of the date of acquisition.

(b) Intangible assets

Under the Group's UK GAAP accounting policy, goodwill arising on acquisitions after 1 October 1998 is recognised as an asset and amortised on a straight-line basis over its estimated useful economic life. Impairment tests on goodwill are carried out at the end of the first full accounting period after its acquisition, and whenever there are indications of impairment. Goodwill arising on acquisitions before 1 October 1998 was deducted from reserves immediately. Under US GAAP, goodwill is recognised as an asset, and is not amortised. Under the transition rules of SFAS 142 *Goodwill and Other Intangible Assets*, no amortisation is charged on acquisitions made after 30 June 2001; amortisation is charged up to 31 December 2001 for other goodwill. All goodwill and intangible assets with indefinite lives are tested for impairment at least annually. Certain amounts included in goodwill under UK GAAP are classified as intangible assets under US GAAP and amortised over their useful economic lives.

(c) Property revaluation and depreciation

The Group's freehold and leasehold properties are carried at original cost or subsequent valuation. The surplus or deficit on revaluation is included in the Group's reserves. Under US GAAP, revaluations of property are not permitted to be reflected in the financial statements.

Depreciation charged and gains or losses on disposal under UK GAAP are based on the revalued amount of freehold and long leasehold properties; no depreciation is charged on investment properties which are revalued annually. Under US GAAP, the depreciation charge and gains or losses on disposal are based on the historical cost for all properties.

(d) Leasehold property provisions

Under UK GAAP, provisions are raised on leasehold properties when there is a commitment to vacate the property. US GAAP requires provisions to be recognised at the time the property is vacated.

(e) Dividends

Under UK GAAP, dividends are recorded in the period to which they relate, whereas under US GAAP dividends are recorded in the period in which they are declared.

(f) Loan origination

Under UK GAAP, certain loan fees are recognised when received. Under US GAAP, applicable non-refundable loan fees and certain direct costs are deferred and recognised over the period of the related loan or facility.

(g) Pension costs

Under UK GAAP, pension assets are measured at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit method and discounted at the current rate of return on a high quality corporate bond of equivalent term and currency. Any surplus or deficit of

Notes on the accounts continued**53 Significant differences between UK and US generally accepted accounting principles** *(continued)*

scheme assets compared with liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit). An asset is only recognised to the extent that the surplus can be recovered through reduced contributions in the future or through refunds from the scheme. US GAAP requires a similar method but allows a certain portion of actuarial gains and losses to be deferred and allocated in equal amounts over the average remaining service lives of current employees. A minimum additional liability must be recognised if the accumulated benefit obligation (the current value of accrued benefits without allowance for future salary increases) exceeds the fair value of plan assets and the Group has recorded a prepaid pension costs or has an accrued liability that is less than the unfunded accumulated benefit. Movements in the minimum additional liability, together with the related deferred tax, are recognised through other comprehensive income.

(h) Long-term assurance business

The shareholders' interest in the long-term assurance fund is valued as the discounted value of the cash flows expected to be generated from in-force policies together with net assets in excess of the statutory liabilities. Under US GAAP, for traditional business, premiums are recognised as revenue when due from the policyholders. Costs of claims are recognised when insured events occur. A liability for future policy benefits is established based upon the present value of future benefits less the present value of future net premiums. Acquisition costs for traditional business contracts are charged to the profit and loss account in proportion to premium revenue recognised. For unit-linked business, premiums and front-end load-type charges receivable from customers and acquisition costs relating to the acquisition of new contracts are capitalised and depreciated in proportion to the present value of estimated gross profits. Costs of claims are recognised when insured events occur.

(i) Extinguishment of liabilities

Under UK GAAP, recognition of a financial liability ceases once any transfer of economic benefits to the creditor is no longer likely. Under US GAAP, a financial liability is derecognised only when the creditor is paid or the debtor is legally released from being the primary obligator under the liability, either judicially or by the creditor.

(j) Leasing

In accordance with UK GAAP, the Group's accounting policy for finance lease income receivable is to allocate total gross earnings to accounting periods so as to give a constant periodic rate of return on the net cash investment, and certain operating lease assets are depreciated on a reverse-annuity basis. Under US GAAP, finance lease income is recognised so as to give a level rate of return on the investment in the lease but without taking into account the associated tax flows, and all operating lease assets are depreciated on a straight-line basis.

(k) Securities

Under UK GAAP, the Group's debt securities and equity shares are classified as being held as investment securities or for dealing purposes. Investment securities are stated at cost less provision for any permanent diminution in value. Premiums and discounts on dated debt securities are amortised to interest income over the period to maturity. Securities held for dealing purposes are carried at fair value with changes in fair value recognised in the profit and loss account. Under US GAAP, securities held by the Group's private equity business are considered to be held by investment companies and are carried at fair value, with changes in fair value being reflected in net income. The Group's other investment debt securities and marketable investment equity shares are classified as available-for-sale securities with unrealised gains and losses reported in a separate component of equity, except when the unrealised loss is considered other than temporary in which case the loss is included in net income. Under US GAAP, the Group recognises an other than temporary impairment on an available-for-sale equity share when its carrying value has exceeded its market value for more than twelve months.

(l) Derivatives and hedging activities

SFAS 133 Accounting for Derivative Instruments and Hedging Activities was effective for the Group's US GAAP information from 1 January 2001. The Group has not made changes in its use of non-trading derivatives to meet the hedge criteria of SFAS 133. As a

result, from 1 January 2001, for US GAAP purposes, the Group's portfolio of non-trading derivatives has been remeasured to fair value and changes in fair value reflected in net income. Under UK GAAP, these derivatives continue to be classified as non-trading and accounted for in accordance with the underlying transaction or transactions being hedged.

SFAS 133 does not permit a non-derivative financial instrument to be designated as the hedging instrument in a fair value hedge of the foreign exchange exposure of available-for-sale securities.

SFAS 133 also requires derivatives embedded in other financial instruments to be accounted for on a stand-alone basis if they have economic characteristics and risks that differ from those of the host instrument.

US GAAP does not permit a profit or loss to be recognised on transacting a derivative unless its valuation is based on observable market data. There is no similar requirement under UK GAAP. Inception profits and losses reflecting the application of the Group's usual pricing methodologies are recognised as they arise.

(m) Software development costs

Under UK GAAP, most software development costs are written off as incurred. Under US GAAP, certain costs relating to software developed for own use that are incurred after 1 January 1999 are capitalised and depreciated over the estimated useful life of the software.

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(n) Share-based compensation

Under UK GAAP, no compensation expense is recognised for the Group's executive share option schemes, under which options are granted at the higher of nominal value and market value on the date of grant and for the Group's Sharesave schemes, under which employees are granted options at a 20% discount to market value at date of grant. Under US GAAP, the compensation expense based on the options' intrinsic value is charged to the profit and loss account over the period to their average vesting date.

(o) Consolidation

UK GAAP requires consolidation of entities controlled by an enterprise where control means the enterprise's ability to direct the financial and operating policies of an entity with a view to gaining economic benefits. US GAAP requires consolidation by the primary beneficiary of a variable interest entity (VIE). An enterprise is the primary beneficiary of a VIE if it will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both.

(p) Acceptances

Acceptances outstanding and the matching customers' liabilities are not reflected in the consolidated balance sheet, but are disclosed as memorandum items. Under US GAAP, acceptances outstanding and the matching customers' liabilities are reflected in the consolidated balance sheet.

(q) Offset arrangements

Under UK GAAP, debit and credit balances with the same counterparty are aggregated into a single item where there is a right to insist on net settlement and the debit balance matures no later than the credit balance. Under US GAAP, agreements and balances with the same counterparty may be offset only where they have the same settlement date specified at inception and there is an intention to set off.

(r) Deferred taxation

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Accounting for deferred tax under UK GAAP is consistent with US GAAP except that deferred tax is not recognised under UK GAAP on certain timing differences resulting from the roll-over of gains on disposal of properties, but is provided under US GAAP on such differences.

Recent developments in US GAAP

The FASB issued SFAS 153 Exchanges of Nonmonetary assets, an amendment of APB Opinion No. 29 in December 2004. SFAS 153 provides for a general exception from fair value measurement for exchanges of nonmonetary assets that do not have commercial substance. The Statement is effective for fiscal years beginning after 15 June 2005 and is not expected to affect the Group's US GAAP reporting.

In December 2004, the FASB issued SFAS 123 (revised 2004) Share-Based Payment which requires compensation costs related to share-based payment transactions to be recognised in the financial statements. The compensation cost will be based on the grant-date fair value of the equity issued and will be recognised over the period that an employee provides service in exchange for the award. SFAS 123 (revised 2004) would be effective for the Group from 1 January 2006. Entities that use the fair value method for either recognition or disclosure under SFAS 123 will apply the revised Statement using a modified version of prospective application whereby for that portion of outstanding awards for which the requisite service has not yet been rendered, compensation cost will be based on the grant-date fair value calculated under SFAS 123 for either recognition or pro forma disclosures. For periods before the effective date, entities may elect to apply a modified version of retrospective application under which financial statements for prior periods are adjusted on a basis consistent with the pro forma disclosures required by SFAS 123. The Group currently makes pro forma disclosures of the effect on net income of compensation costs determined under the fair value method of SFAS 123.

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Notes on the accounts continued

53 Significant differences between UK and US generally accepted accounting principles *(continued)*

Selected figures in accordance with US GAAP

The following tables summarise the significant adjustments to consolidated net income available for ordinary shareholders and shareholders' equity which would result from the application of US GAAP instead of UK GAAP. Where applicable, the adjustments are stated gross of tax with the tax effect shown separately in total.

| Consolidated statement of income | 2004 £m | 2003 £m | 2002 £m |
|--|------------|------------|------------|
| Profit attributable to ordinary shareholders UK GAAP | 4,256 | 2,254 | 2,034 |
| Adjustments in respect of: | | | |
| Acquisition accounting | 66 | 33 | |
| Amortisation of intangible assets | 780 | 721 | 681 |
| Property revaluation and depreciation | (69) | (41) | (18) |
| Leasehold property provisions | (19) | 83 | |
| Loan origination | (85) | (47) | (72) |
| Pension costs | (285) | (286) | (121) |
| Long-term assurance business | (27) | (57) | (37) |
| Extinguishment of liabilities | (94) | (84) | |
| Leasing | (35) | (53) | (71) |
| Securities | (170) | 49 | |

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| | | | |
|--|-------|-------|-------|
| Derivatives and hedging | (437) | 232 | 770 |
| Software development costs | (261) | (300) | 283 |
| Share-based payment | (26) | (32) | |
| Consolidation | (29) | (60) | |
| Tax effect on the above adjustments | 395 | 165 | (261) |
| Deferred taxation | (12) | (13) | (80) |
| <hr/> | | | |
| Net income available for ordinary shareholders US GAAP | 3,948 | 2,564 | 3,108 |

| | 2004 £m | 2003 £m |
|---|------------|------------|
| Consolidated shareholders equity | | |
| <hr/> | | |
| Shareholders funds UK GAAP | 31,865 | 26,098 |
| Adjustments in respect of: | | |
| Acquisition accounting | 517 | 451 |
| Intangible assets | 3,002 | 2,222 |
| Property revaluation and depreciation | (262) | (249) |
| Leasehold property provisions | 64 | 83 |
| Proposed dividend | 1,308 | 1,059 |
| Loan origination | (373) | (288) |
| Pension costs | 190 | 2,828 |
| Long-term assurance business | (205) | (178) |
| Extinguishment of liabilities | (178) | (84) |
| Leasing | (253) | (218) |
| Securities | 134 | 232 |
| Derivatives and hedging | 238 | 161 |
| Software development costs | 399 | 660 |
| Share-based payment | (58) | (32) |
| Consolidation | (89) | (60) |
| Tax effect on cumulative UK/US GAAP adjustments | (733) | (1,128) |
| Tax effect on other comprehensive income | 684 | 155 |
| Deferred tax | (59) | (47) |
| <hr/> | | |
| Shareholders equity US GAAP | 36,191 | 31,665 |

Prior periods have been restated following the implementation of FRS 17 and the reclassification of perpetual regulatory securities.

Total assets under US GAAP, adjusted to reflect the consolidation of variable interest entities, inclusion of acceptances, provisions for contingent liabilities and commitments, the fair value of financial guarantees and the grossing-up of certain netting arrangements under UK GAAP, together with the effect of adjustments made to net income and shareholders funds, were £631 billion (2003 £488 billion).

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Basic and diluted earnings per share (EPS) under US GAAP differ from UK GAAP only to the extent that the income calculated under US GAAP differs from that under UK GAAP.

| | 2004 | | | 2003 | | | 2002 | | |
|--|---------|---------------|------------------|---------|---------------|------------------|---------|---------------|------------------|
| | Income* | No. of shares | Per share amount | Income* | No. of shares | Per share amount | Income* | No. of shares | Per share amount |
| | £m | million | pence | £m | million | pence | £m | million | pence |
| Basic EPS | 3,948 | 3,085 | 128.0 | 2,564 | 2,931 | 87.5 | 3,108 | 2,881 | 107.9 |
| Dilutive effect of share options and convertible preference shares | 66 | 73 | (0.9) | | 22 | (0.7) | | 43 | (1.6) |
| Diluted EPS | 4,014 | 3,158 | 127.1 | 2,564 | 2,953 | 86.8 | 3,108 | 2,924 | 106.3 |

* US GAAP net income available to ordinary shareholders, see page 136.

The Group has convertible preference shares totalling £200 million (2003 and 2002 £200 million) £750 million (2003 and 2002 £750 million) and \$1,900 million (2003 and 2002 \$1,900 million). All of the convertible preference shares, with the exception of \$1,500 million, have a dilutive effect in the current year and as such have been included in the computation of diluted earnings per share.

Outstanding options to purchase shares are excluded from the computation of diluted EPS where the exercise prices of the options are greater than the average market price of the ordinary shares during the relevant period. At 31 December 2004, there were 8.7 million such options outstanding (2003 5.2 million; 2002 3.8 million).

Pensions

On 1 April 2002, the Group's main pension schemes, The Royal Bank of Scotland Staff Pension Scheme and the National Westminster Bank Pension Fund, were merged to form The Royal Bank of Scotland Group Pension Fund (the plan). The provisions of SFAS 87 Employers Accounting for Pensions have been applied to the plan, which covers most of the Group's UK employees; the impact of US GAAP on the other Group schemes is considered to be immaterial.

A trust fund has been established under the plan, to which payments are made, determined on an actuarial basis, designed to build up reserves during the working life of full-time employees to pay such employees or their dependants a pension after retirement. Such pensions are based on final pensionable salaries and are related to the length of service prior to retirement. Pensions are limited to a maximum of two-thirds of final salary for 40 years service or more. Staff do not make contributions for basic pensions but may make voluntary contributions on a regular basis to purchase additional service qualification where less than 40 years service will have been completed by normal retirement age.

The assets of the plan are held under separate trusts and, in the long-term, the funding policy is to maintain assets sufficient to cover the benefits in respect of service to date, with due allowance for future earnings increases. The plan assets consist mainly of fixed-income securities and listed securities. The investment policy followed for the plan seeks to deploy the plan assets primarily in UK and overseas equity shares and UK government securities.

Disclosures required by SFAS 132R for the Group's main scheme are set out below.

Obligations and funded status

| | 2004 | 2003 | 2002 |
|---|--------|--------|--------|
| | £m | £m | £m |
| Change in benefit obligation: | | | |
| Projected benefit obligation at beginning of year | 13,963 | 12,526 | 12,198 |
| Service cost | 420 | 340 | 303 |
| Interest cost | 768 | 706 | 715 |
| Net actuarial loss/(gain) | 1,568 | 902 | (217) |
| Benefits and expenses paid | (527) | (511) | (473) |

| | | | |
|--|------------|------------|------------|
| Projected benefit obligation at year end | 16,192 | 13,963 | 12,526 |
| Change in plan assets: | 2004 £m | 2003 £m | 2002 £m |
| Fair value of plan assets at beginning of year | 11,822 | 10,682 | 12,567 |
| Actual return on plan assets | 1,234 | 1,559 | (1,521) |
| Employer's contribution | 1,069 | 92 | 109 |
| Benefits and expenses paid | (527) | (511) | (473) |
| Market value of plan assets at year end | 13,598 | 11,822 | 10,682 |

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Notes on the accounts continued

53 Significant differences between UK and US generally accepted accounting principles (continued)

Pensions (continued)

| | | | |
|--|------------|------------|------------|
| Prepaid pension cost: | 2004 £m | 2003 £m | 2002 £m |
| Funded status | (2,594) | (2,141) | (1,844) |
| Unrecognised net actuarial loss | 5,990 | 5,078 | 5,266 |
| Unrecognised prior service cost | 12 | 13 | 14 |
| Unrecognised transition amount | (6) | (14) | (22) |
| Prepaid pension cost at year end | 3,402 | 2,936 | 3,414 |
| Components of net periodic pension cost: | 2004 £m | 2003 £m | 2002 £m |
| Service cost | 420 | 340 | 303 |
| Interest cost | 768 | 706 | 715 |
| Expected return on plan assets | (840) | (757) | (901) |
| Amortisation of prior service cost | 1 | 1 | 1 |
| Amortisation of loss | 263 | 287 | 138 |
| Amortisation of net transition asset | (8) | (8) | (8) |
| Net periodic pension cost | 604 | 569 | 248 |

Assumptions

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| Weighted average assumptions used at 31 December: | 2004 % per annum | 2003 % per annum | 2002 % per annum |
|---|---------------------|---------------------|---------------------|
| Discount rate for liabilities | 5.40 | 5.60 | 5.75 |
| Salary increases | 3.95 | 3.95 | 3.50 |
| Pension increases | 2.70 | 2.70 | 2.25 |
| Long-term rate of return on assets | 6.95 | 7.20 | 7.20 |

| Weighted-average allocations of market value of plan assets at 31 December: | 2004 % | 2003 % | 2002 % |
|---|-----------|-----------|-----------|
| Equity shares | 57 | 65 | 67 |
| Debt securities | 31 | 32 | 31 |
| Other | 12 | 3 | 2 |
| Total | 100 | 100 | 100 |

At 31 December 2004, the fund's accumulated benefit obligation was underfunded by £561 million (2002 £168 million). This resulted in a reduction in the accumulated other comprehensive income component of US GAAP shareholders' equity of £3,951 million (2002 £3,568 million), comprising the excess of the accumulated benefit obligation over the market value of assets of £561 million (2002 £168 million), prepaid pension cost of £3,402 million (2002 £3,414 million) less unrecognised prior service cost of £12 million (2002 £14 million). This was reduced by deferred tax of £1,185 million (2002 £1,070 million). At 31 December 2003, the fund had a surplus of assets over its accumulated benefit obligation and no minimum liability was recognised.

Cash flows

The following pension payments under the main scheme, which reflect expected future service, as appropriate, are expected to be paid:

| | £m |
|------------|-------|
| 2005 | 511 |
| 2006 | 521 |
| 2007 | 530 |
| 2008 | 543 |
| 2009 | 557 |
| After 2010 | 3,072 |

The Group expects to contribute £376 million to its main UK pension plan in 2005.

Loan impairment

At 31 December 2004 and 2003, the Group estimated that the difference between the carrying value of its loan portfolio under US GAAP and its value in the Group's UK GAAP financial statements was such that no adjustment to net income or consolidated

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shareholders' equity was required. At 31 December 2004, the Group's non-accrual loans, loans past due 90 days and troubled debt restructurings amounted to £5,529 million (2003 £5,157 million). Specific provisions of £3,602 million (2003 £2,782 million) were held against these loans. Average non-accrual loans, loans past due 90 days and troubled debt restructurings for the year to 31 December 2004 were £5,313 million (2003 £5,166 million).

Gross interest income not recognised, but which would have been recognised under the original terms of non-accrual and restructured loans, amounted to £237 million for the year ended 31 December 2004 (2003 £237 million; 2002 £234 million) from domestic loans and £58 million for the year ended 31 December 2004 (2003 £55 million; 2002 £73 million) from foreign loans. Interest on non-accrual and restructured loans included in net income was £58 million for the year ended 31 December 2004 (2003 £60 million; 2002 £47 million) from domestic loans and £7 million for the year ended 31 December 2004 (2003 £3 million; 2002 £7 million) from foreign loans.

Securities

During 2004, net gains of £2 million were included in US GAAP net income from transfers of securities from the available-for-sale category into the trading category. For 2004, net unrealised losses of £924 million on available-for-sale securities were included in US GAAP other comprehensive income and £672 million was reclassified from accumulated other comprehensive income into US GAAP net income.

The table below shows the fair value of available-for-sale securities that were in an unrealised loss position at 31 December 2004.

| | Less than 12 months | | More than 12 months | | Total | | |
|---|---------------------|---------------|----------------------------|---------------|----------------------------|---------------|----------------------------|
| | Number of issues | Fair value £m | Gross unrealised losses £m | Fair value £m | Gross unrealised losses £m | Fair value £m | Gross unrealised losses £m |
| UK government | | | | 512 | 20 | 512 | 20 |
| US treasury and government and securities issued by US states | | 507 | 24 | | | 507 | 24 |
| Other government | | 855 | 18 | 47 | 2 | 902 | 20 |
| Corporate debt securities | | 73 | 4 | 75 | 5 | 148 | 9 |
| Mortgage-backed securities | | 3,651 | 66 | 906 | 28 | 4,557 | 94 |
| Bank and building society | | 29 | 4 | 51 | 1 | 80 | 5 |
| Other | | 8 | 1 | | | 8 | 1 |
| Available-for-sale debt securities | 516 | 5,123 | 117 | 1,591 | 56 | 6,714 | 173 |

The Group considers that unrealised losses on available-for-sale debt securities are temporary principally because they reflect changes in benchmark interest rates. In 2004, other than temporary losses of £78 million have been recognised in net income on available-for-sale equity shares.

Notes on the accounts continued

53 Significant differences between UK and US generally accepted accounting principles (continued)

Cash flow statements

There are many similarities between SFAS 95, Statement of Cash Flows as amended by SFAS 104 Statement of Cash Flows Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions, and FRS 1 Cash Flow Statements (Revised). The principal differences are the classifications of certain transactions.

| | Classification under FRS 1 | Classification under SFAS 95 |
|---|---|------------------------------|
| Equity dividends paid | Equity dividends paid | Financing activities |
| Dividends paid on non-equity shares | Returns on investments and servicing of finance | Financing activities |
| Tax paid | Taxation | Operating activities |
| Purchase and sale of associated and subsidiary undertakings | Acquisitions and disposals | Investing activities |
| Purchase and sale of investment securities and fixed assets | Capital expenditure and financial investment | Investing activities |
| Net change in loans and advances, including finance lease receivables | Operating activities | Investing activities |
| Net change in deposits | Operating activities | Financing activities |
| Net change in debt securities in issue | Operating activities | Financing activities |
| Short-term funding not included in cash | Operating activities | Financing activities |

Summary consolidated statements of cash flows presented on a US GAAP basis for each of the three years ended 31 December 2004 are set out below:

| | 2004 £m | 2003 £m | 2002 £m |
|--|------------|------------|------------|
| Cash flows from operating activities | 8,062 | 8,534 | 11,008 |
| Cash flows from investing activities | (82,113) | (31,879) | (44,892) |
| Cash flows from financing activities | 77,644 | 34,872 | 37,245 |
| Effect of exchange rate changes on cash and cash equivalents | (807) | (863) | (115) |
| Change in cash and cash equivalents | 2,786 | 10,664 | 3,246 |
| Cash and cash equivalents at beginning of the year | 20,937 | 10,273 | 7,027 |
| Cash and cash equivalents at end of the year | 23,723 | 20,937 | 10,273 |

The composition of cash at 31 December 2004, 2003 and 2002 and the movement in cash for the years then ended are shown in Note 47 and Note 48 on the accounts respectively.

Stock-based compensation costs

The Group grants share options to executive officers under an executive share option scheme (the executive scheme) and to employees under a savings-related sharesave scheme (the savings scheme) and the option 2000 scheme.

Executive scheme

Under the terms of the executive scheme, senior management employees and executive directors of Group companies may participate in the executive scheme at the discretion of the Board of directors of the company. The executive scheme involves a participant being granted an option to subscribe for ordinary shares of the company at the higher of nominal value and market value of ordinary shares on the date of grant. Normally, options may be granted only within six weeks after the announcement of final or interim results of the Group for any particular year. Options may not be transferred or assigned. A participant may not be granted options over new shares to the extent that the aggregate subscription price would exceed four times his compensation.

Options granted under the executive scheme are issued on a UK Inland Revenue approved or unapproved basis. Options are exercisable between the third and tenth anniversaries of the grant date, only if performance criteria are met. For options granted from 1996 to 1998, the criterion is the average growth in adjusted earnings per ordinary share to exceed the average increase in the UK Retail Prices Index by 2% per annum over a three year period. For options granted since 1999, the relevant percentage has been increased to 3% per annum.

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Savings scheme

Under the Inland Revenue rules, a participant in a savings scheme is permitted to make a maximum monthly saving of £250 under approved savings schemes. Employees of Group companies in the UK and Ireland and certain offshore jurisdictions are offered participation in the savings scheme. Participants can make monthly savings for a period of three, five or seven years. Options may be granted at not less than 80% of the average market value of ordinary shares of the company by reference to dealings in the ordinary shares over the last three trading days of the week immediately preceding the date of an invitation to participate, or, if higher, at par. Options comprise, as nearly as possible, such number of ordinary shares as may be purchased at the option price with the proceeds on maturity after either three, five or seven years of the savings contract, and options may normally be exercised only within six months after the third, fifth or seventh anniversary of the savings contract. Options may not be transferred or assigned.

Option 2000 scheme

On 9 August 2000 and again on 4 April 2001, every qualifying permanent member of staff in the Group received an option over 150 shares in the company. The executive directors of the company waived their entitlement to the option granted on 4 April 2001. Further grants over 150 shares have been made on three separate occasions to employees joining the Group by way of acquisition, including a grant on 1 September 2004 to all employees of Charter One.

Under the scheme, options are granted at the market value of ordinary shares at the date of grant and may normally be exercised only between the third and sixth anniversary of the date of grant.

Limitations of the option schemes:

- (i) During a ten year period, no more than 10% in aggregate of the issued ordinary share capital of the company from time to time may be issued pursuant to all of the employee share schemes operated by the company.
- (ii) During a five year period, no more than 5% in aggregate of the issued ordinary share capital of the company from time to time may be issued pursuant to all of the employee share schemes operated by the company.
- (iii) During a ten year period, no more than 5% in aggregate of the issued ordinary share capital of the company from time to time may be issued pursuant to the executive scheme.
- (iv) During a four year period, no more than 2 ½% in aggregate of the issued ordinary share capital of the company from time to time may be issued pursuant to the executive scheme.
- (v) During a three year period, no more than 3% in aggregate of the issued ordinary share capital of the company from time to time may be issued pursuant to the executive scheme.

The following is a summary of outstanding options under the various schemes:

| Savings scheme | Executive scheme | Option 2000 scheme | Total |
|----------------|------------------|--------------------|-------|
|----------------|------------------|--------------------|-------|

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| | Number of options 000 s | Weighted average exercise price pence | Number of options 000 s | Weighted average exercise price pence | Number of options 000 s | Weighted average exercise price pence | Number of options 000 s | Weighted average exercise price pence |
|---------------------|----------------------------------|--|----------------------------------|--|----------------------------------|--|----------------------------------|--|
| At 1 January 2002 | 51,604 | 829 | 12,033 | 996 | 26,584 | 1399 | 90,221 | 1019 |
| Granted | 12,419 | 1235 | 2,096 | 1810 | 620 | 1841 | 15,135 | 1339 |
| Exercised | (12,112) | 493 | (3,160) | 729 | (5) | 1380 | (15,277) | 542 |
| Forfeited | (2,271) | 1025 | (145) | 940 | (1,313) | 1419 | (3,729) | 1160 |
| At 31 December 2002 | 49,640 | 1003 | 10,824 | 1232 | 25,886 | 1409 | 86,350 | 1153 |
| Granted | 9,100 | 1307 | 4,073 | 1347 | 1,363 | 1590 | 14,536 | 1345 |
| Exercised | (11,902) | 747 | (1,299) | 798 | (6,380) | 1240 | (19,581) | 911 |
| Forfeited | (2,715) | 1117 | (76) | 1251 | (1,603) | 1459 | (4,394) | 1244 |
| At 31 December 2003 | 44,123 | 1128 | 13,522 | 1308 | 19,266 | 1474 | 76,911 | 1246 |
| Granted | 11,216 | 1205 | 4,341 | 1723 | 1,269 | 1553 | 16,826 | 1365 |
| Exercised | (10,675) | 883 | (1,079) | 994 | (6,715) | 1439 | (18,469) | 1092 |
| Forfeited | (2,339) | 1214 | (171) | 1298 | (948) | 1428 | (3,458) | 1277 |
| At 31 December 2004 | 42,325 | 1205 | 16,613 | 1437 | 12,872 | 1503 | 71,810 | 1312 |

In 2004, awards totalling 373,140 options (2003 341,269; 2002 59,869) with negligible exercise prices and 93,367 shares (2003 59,525; 2002 nil) were made under the Group's medium-term performance plan. Under the plan, the amount of shares or options that vest ranges from nil to 200% of the award depending on the annual growth in the Group's earnings per share and its performance relative to that of a comparator group of companies principally from the UK financial services sector.

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Notes on the accounts continued

53 Significant differences between UK and US generally accepted accounting principles (continued)

Stock-based compensation costs (continued)

The following table shows options outstanding by normal exercise date. An option life of 5 years, being the midpoint on the 10 year option, has been assumed for options granted under Group and former NatWest executive plans.

| Year exercisable | 2004 | | 2003 | | 2002 | |
|------------------|----------------------------------|--|----------------------------------|--|----------------------------------|--|
| | Number of options 000 s | Weighted average exercise price pence | Number of options 000 s | Weighted average exercise price pence | Number of options 000 s | Weighted average exercise price pence |
| 2003 | | | | | 27,769 | 963 |

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| | | | | | | |
|-------|--------|------|--------|------|--------|------|
| 2004 | | | 31,817 | 1188 | 25,553 | 1226 |
| 2005 | 26,117 | 1214 | 14,081 | 1112 | 15,473 | 1118 |
| 2006 | 10,832 | 1421 | 11,822 | 1421 | 6,924 | 1447 |
| 2007 | 14,360 | 1324 | 8,785 | 1351 | 9,265 | 1343 |
| 2008 | 8,760 | 1327 | 9,110 | 1328 | 494 | 1364 |
| 2009 | 10,549 | 1423 | 809 | 1235 | 872 | 1235 |
| 2010 | 429 | 1307 | 487 | 1307 | | |
| 2011 | 763 | 1209 | | | | |
| Total | 71,810 | 1312 | 76,911 | 1246 | 86,350 | 1153 |

If the compensation cost for the schemes had been determined based on the fair value at the grant dates consistent with the fair value method of SFAS 123, net income and earnings per share as adjusted to include stock compensation would have been as shown below:

| | 2004 £m | 2003 £m | 2002 £m |
|---|------------|------------|------------|
| Net income under US GAAP: | | | |
| As reported | 3,948 | 2,564 | 3,108 |
| Adjusted to include stock compensation | 3,909 | 2,503 | 2,978 |
| Basic earnings per share under US GAAP: | | | |
| As reported | 128.0p | 87.5p | 107.9p |
| Adjusted to include stock compensation | 126.7p | 85.4p | 103.4p |
| Diluted earnings per share under US GAAP: | | | |
| As reported | 127.1p | 86.8p | 106.3p |
| Adjusted to include stock compensation | 125.9p | 84.8p | 101.8p |

The fair value of each option has been estimated as at the grant date using a Black-Scholes option pricing model using the following assumptions:

| | 2004 | | 2003 | | 2002 | |
|--|------------------|------|------------------|------|------------------|------|
| Risk free interest rate | 4.8% | 5.2% | 3.6% | 4.6% | 4.7% | 4.9% |
| Volatility based on historical data | 18% | | 29% | | 43% | |
| Dividend yield | 3.3% | 3.7% | 2.9% | 4.1% | 2.4% | 2.9% |
| Expected lives of options granted under: | | | | | | |
| Employee savings scheme | 3, 5 and 7 years | | 3, 5 and 7 years | | 3, 5 and 7 years | |
| Executive scheme | 3 to 10 years | | 3 to 10 years | | 3 to 10 years | |
| Option 2000 scheme | 3 years | | 3 years | | 3 years | |

The following table summarises fair values of options issued in each year:

| | 2004 | | | 2003 | | | 2002 | | |
|----------------------|---------------------|-----------------|---------------|---------------------|-----------------|---------------|---------------------|-----------------|---------------|
| | Exercise price £ | Fair value £ | Life Years | Exercise price £ | Fair value £ | Life Years | Exercise price £ | Fair value £ | Life Years |
| Executive scheme (1) | 16.98 | 2.85 | 3 -10 | 13.48 | 2.91 | 3 -10 | 18.10 | 6.54 | 3 -10 |
| Savings scheme | | | | | | | | | |
| 3 year | 13.07 | 3.83 | 3 | 13.07 | 4.64 | 3 | 12.35 | 5.58 | 3 |

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| | | | | | | | | | |
|--------------------|-------|------|---|-------|------|---|-------|------|---|
| 5 year | 13.07 | 4.09 | 5 | 13.07 | 5.15 | 5 | 12.35 | 6.33 | 5 |
| 7 year | 13.07 | 4.24 | 7 | 13.07 | 5.48 | 7 | 12.35 | 6.76 | 7 |
| Option 2000 scheme | 15.53 | 1.93 | 3 | 15.90 | 2.91 | 3 | 18.41 | 5.44 | 3 |

Note:

- (1) For the purposes of calculating a fair value on executive scheme options, an option life of 5 years, being the mid-point on the 10 year option, has been assumed. Historical exercise trends have not been used as these are not felt to be indicative of future trends given changes to the scheme rules and participants in the scheme.

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Goodwill and intangible assets other than goodwill

The Group fully implemented SFAS 142 Goodwill and Other Intangible Assets from 1 January 2002. Under this standard, goodwill and intangible assets deemed to have indefinite lives are not amortised and are subject to annual impairment tests. Other intangible assets continue to be amortised over their useful lives. The Group has completed the impairment tests required under SFAS 142 and no impairment has been recognised as a result.

Intangible assets other than goodwill

A summary of the carrying value of intangible assets other than goodwill is as follows:

| | 2004 | | | 2003 | | | 2002 | | |
|---|-----------------------------|--------------------------------|---------------------------|-----------------------------|--------------------------------|---------------------------|-----------------------------|--------------------------------|---------------------------|
| | Gross carrying amount £m | Accumulated amortisation £m | Net carrying amount £m | Gross carrying amount £m | Accumulated amortisation £m | Net carrying amount £m | Gross carrying amount £m | Accumulated amortisation £m | Net carrying amount £m |
| Core deposit intangibles | 690 | (205) | 485 | 459 | (149) | 310 | 461 | (108) | 353 |
| Brands | 367 | (3) | 364 | 338 | | 338 | | | |
| Others | 360 | (39) | 321 | 128 | (6) | 122 | | | |
| Total amortising intangible assets | 1,417 | (247) | 1,170 | 925 | (155) | 770 | 461 | (108) | 353 |

The weighted average amortisation period of intangible assets, other than goodwill, subject to amortisation are:

| | Years |
|--------------------------|-------|
| Core deposit intangibles | 7 |
| Brands | 10 |
| Others | 8 |

Amortisation charge on intangibles during 2004 was £115 million (2003 £62 million; 2002 £50 million). The Group estimates amortisation expense for the next five years will be:

£m

| | |
|------|-----|
| 2005 | 146 |
| 2006 | 145 |
| 2007 | 141 |
| 2008 | 133 |
| 2009 | 123 |

Securitisations

The Group engages in securitisation activities pertaining to certain of its assets including US commercial and residential mortgage loans, commercial and residential mortgage related securities, US Government agency collateralised mortgage obligations, and other types of financial assets. Additionally, the Group acts as an underwriter and depositor in securitisation transactions involving both client and proprietary transactions. The Group has classified these activities into three broad securitisation categories, US Agency based, consumer based, and commercial based securitisations.

During 2004, the Group received proceeds of approximately £31.4 billion (2003 £37.5 billion) from securitisation trusts in connection with new securitisations.

The Group recognised net pre-tax gains of approximately £111.1 million (2003 £58.8 million) relating to these securitisations. Net pre-tax gains are based on the difference between the sales prices and previous carrying values of assets prior to date of sale, are net of transaction specific expenses, and exclude any results attributable to hedging activities, interest income, funding costs, changes in asset values prior to securitisation date, and retained interest values subsequent to securitisation date.

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Notes on the accounts *continued*

53 Significant differences between UK and US generally accepted accounting principles *(continued)*

Securitisations *(continued)*

In some instances, the Group retained certain interests. The Group typically does not retain a significant portion of the loans or securities that it securitises. This reduces the impact that changes to fair values of retained interests might have on the Group's financial results.

The Group's retained interests may be subordinated to other investors' interests. The investors and securitisation trusts have no recourse to the Group's other assets for failure of debtors to perform on the securitised loans or securities. The value of the retained interests varies and is subject to prepayment, credit and interest rate risks on the transferred assets.

At 31 December 2004, the fair value of the Group's retained interests was approximately £1.4 billion (2003 £1.5 billion). These retained interests comprises approximately £509 million in US Agency based retained interests, £864 million in consumer based retained interests and £56 million in commercial based retained interests. These retained interests primarily relate to mortgage loans and securities and arose from securitisations that have taken place in current and prior years.

Cash flows received in 2004 from retained interests held at 31 December 2004 in connection with securitisations that took place in current and prior years amounted to approximately £383 million (2003 £368 million).

Key economic assumptions used in measuring the value of retained interests at the date of securitisation resulting from securitisations completed during the year were as follows:

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| Assumptions | U.S. Agency retained interests | Consumer retained interests | Commercial retained interests |
|-------------------------|--------------------------------------|-----------------------------------|-------------------------------------|
| Prepayment speed | 184-480 PSA | 4-45% CPR (1) | 0-100 CPY (2) |
| Weighted average life | 1-19 years | 1-16 years | 1-7 years |
| Cash flow discount rate | 2-27% | 2-78% | 2-12% |
| Credit losses | N/A (3) | 0-2% CDR (4) | N/A (5) |

Key economic assumptions and the sensitivity of the current fair value of retained interests at 31 December 2004 to immediate adverse changes, as indicated below, in those assumptions are as follows:

| Assumptions/impact on fair value | U.S. Agency retained interests | Consumer retained interests | Commercial retained interests |
|--|--------------------------------------|-----------------------------------|-------------------------------------|
| Fair value of retained interests at 31 December 2004 | £509m | £864m | £56m |
| Prepayment speed (6) | 12-35% CPR (1) | 4-45% CPR (1) | 0-100% CPY (2) |
| Impact on fair value of 10% adverse change | £0.3m | £16.6m | |
| Impact on fair value of 20% adverse change | £0.4m | £32.8m | |
| Weighted average life | 1-18 years | 1-11 years | 1-7 years |
| Cash flow discount rate | 2-33% | 2-78% | 2-12% |
| Impact on fair value of 10% adverse change | £9.4m | £20.0m | £0.6m |
| Impact on fair value of 20% adverse change | £18.4m | £38.7m | £1.2m |
| Credit losses | N/A(3) | 0-2% CDR (4) | N/A(5) |
| Impact on fair value of 10% adverse change | N/A | £7.0m | N/A |
| Impact on fair value of 20% adverse change | N/A | £14.3m | N/A |

Notes:

- (1) Constant prepayment rate the CPR range represents the low and high points of a dynamic CPR curve.
- (2) CPR with yield maintenance provision.
- (3) Population consists of securities whose collateral is guaranteed by US Government Sponsored Entities and therefore, no credit loss has been assumed.
- (4) Constant default rate.
- (5) Population consists of only investment grade senior tranches; therefore, no credit losses are included in the assumptions at deal settlement.
- (6) Prepayment speed has been stressed on an overall portfolio basis for US Agency retained interests due to the overall homogeneous nature of the collateral. Consumer and Commercial retained interests have been stressed on a security level basis.

The sensitivities depicted in the preceding table are hypothetical and should be used with caution. The likelihood of those percent variations selected for sensitivity testing is not necessarily indicative of expected market movements because the relationship of the change in the assumptions to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of a retained interest is calculated without changing any other assumptions. This might not be the case in actual market conditions since changes in one factor might result in changes to other factors. Further, the sensitivities depicted above do not consider any corrective actions that the Group might take to mitigate the effect of any adverse changes in one or more key assumptions.

Consolidation*Special purpose entities (SPEs)*

The Group is the primary beneficiary of a number of commercial paper conduits and other asset securitisation vehicles that meet FIN 46R's definition of a variable interest entity. These entities, with total assets of £8.6 billion at 31 December 2004 (2003 £6.9 billion), acquire financial assets from third parties or from the Group funded by the issue of commercial paper or other debt instruments. The Group supplies certain administrative services and provides credit enhancement, liquidity facilities and derivative transactions to some or all of these entities on an arm's length basis. In the case of commercial paper conduits, the Group provides programme-wide credit enhancement by letters of credit or loan facilities across all tranches of assets funded by conduits.

Trust preferred securities

The trust preferred securities referred to in Note 32 on page 113 represent undivided beneficial interests in the assets of trusts, which consist of partnership preferred securities representing non-cumulative perpetual preferred limited partnership interests issued by Delaware limited partnerships. The Group has provided subordinated guarantees for the benefit of the holders of the trust preferred securities and the partnership preferred securities. Under the terms of the guarantees, the Group has fully and unconditionally guaranteed on a subordinated basis, payments on such trust preferred securities and partnership preferred securities, to the extent they are due to be paid and have not been paid by, or on behalf of the trusts and the partnerships, as the case may be.

The trust preferred securities and partnership preferred securities issued by the Group's subsidiaries are deconsolidated, resulting in a US GAAP balance sheet reclassification from minority interests to subordinated liabilities. The effect on US GAAP net income and equity is negligible.

54 The Royal Bank of Scotland Group plc (Parent Company Only)

The following tables present the parent company only financial information:

| Condensed profit and loss account | 2004 £m | 2003 £m | 2002 £m |
|--|--------------|--------------|--------------|
| Dividends receivable from subsidiary undertakings - Banks | 3,004 | 2,680 | 1,949 |
| Total income | 3,004 | 2,680 | 1,949 |
| Net interest payable and operating expenses | 110 | 94 | 34 |
| Profit before tax | 2,894 | 2,586 | 1,915 |
| Tax on profit on ordinary activities | 16 | (33) | (40) |
| Profit after tax | 2,878 | 2,619 | 1,955 |
| Non-equity dividends | 256 | 1,724 | 1,103 |
| Profit attributable to ordinary shareholders | 2,622 | 895 | 852 |
| Ordinary dividends | 1,837 | 1,490 | 1,267 |
| Retained profit / (loss) | 785 | (595) | (415) |
| Condensed balance sheet | 2004 £m | 2003 £m | |

Fixed assets

Investments:

Shares in Group undertakings

| | | |
|----------------------|--------|--------|
| - Banks | 36,286 | 30,862 |
| - Other subsidiaries | 584 | 1,492 |

| | | |
|--|--------|--------|
| | 36,870 | 32,354 |
|--|--------|--------|

Loans to Group undertakings

| | | |
|----------------------|-------|-------|
| - Banks | 2,914 | 3,289 |
| - Other subsidiaries | 1,187 | 1,265 |

| | | |
|--|-------|-------|
| | 4,101 | 4,554 |
|--|-------|-------|

| | | |
|--|--------|--------|
| | 40,971 | 36,908 |
|--|--------|--------|

Current assets

Due by subsidiary undertakings

| | | |
|----------------------|-----|-----|
| - Banks | 363 | 136 |
| - Other subsidiaries | 95 | 102 |

Debtors and prepayments

| | | |
|--|-----|-----|
| | 174 | 202 |
|--|-----|-----|

| | | |
|--|-----|-----|
| | 632 | 440 |
|--|-----|-----|

Creditors: due within one year

| | | |
|--|-------|-------|
| | 3,269 | 3,264 |
|--|-------|-------|

Net current liabilities

| | | |
|--|---------|---------|
| | (2,637) | (2,824) |
|--|---------|---------|

Total assets less current liabilities

| | | |
|--|--------|--------|
| | 38,334 | 34,084 |
|--|--------|--------|

Creditors : due after more than one year

Loans from subsidiary undertakings

| | | |
|----------------------|-----|-----|
| - Banks | 108 | 85 |
| - Other subsidiaries | 54 | 101 |

Loan capital including convertible debt

| | | |
|--|-------|-------|
| | 5,895 | 5,353 |
|--|-------|-------|

| | | |
|--|-------|-------|
| | 6,057 | 5,539 |
|--|-------|-------|

Shareholders' funds

| | | |
|--------------|--------|--------|
| - equity | 27,757 | 25,622 |
| - non-equity | 4,520 | 2,923 |

| | | |
|--|--------|--------|
| | 38,334 | 34,084 |
|--|--------|--------|

Condensed cash flow statement

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

| | | | |
|---|---------|---------|---------|
| Net cash inflow from operating activities | 3,257 | 3,850 | 2,811 |
| Net cash outflow from returns on investments and servicing of finance | (571) | (2,000) | (1,246) |
| Net cash inflow from taxation | 36 | 39 | 35 |
| Net cash outflow from capital expenditure and financial investment | (7,035) | (3,415) | (1,849) |
| Ordinary equity dividends paid | (1,235) | (772) | (729) |
| Net cash outflow before financing | (5,548) | (2,298) | (978) |

| | | | |
|--------------------------------|-------|-------|-------|
| Net cash inflow from financing | 5,628 | 1,853 | 1,380 |
| Increase / (decrease) in cash | 80 | (445) | 402 |

55 Post balance sheet events

There have been no significant events between the year end and the date of approval of these accounts which would require a change to or disclosure in the accounts.

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Additional information

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Additional information

Five year financial summary

The Group's accounts are prepared in accordance with UK GAAP, which differs in certain material respects from US GAAP. For a discussion of such differences and a reconciliation between UK GAAP and US GAAP, see Note 53 on the accounts. The dollar financial information included below has been translated for convenience at the rate of £1.00 to US\$1.916, the Noon Buying Rate on 31 December 2004.

Summary consolidated profit and loss account

| | 2004 \$m | 2004 £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|---|-------------|------------|------------|------------|------------|------------|
| Amounts in accordance with UK GAAP (1) : | | | | | | |
| Net interest income | 17,643 | 9,208 | 8,301 | 7,849 | 6,846 | 5,286 |
| Non-interest income | 25,954 | 13,546 | 10,980 | 9,167 | 7,712 | 5,709 |
| Total income | 43,597 | 22,754 | 19,281 | 17,016 | 14,558 | 10,995 |
| Operating expenses (2, 3) | 20,781 | 10,846 | 9,516 | 9,469 | 8,367 | 6,760 |
| General insurance claims (net) | 6,668 | 3,480 | 2,195 | 1,350 | 948 | 673 |
| Profit before provisions | 16,148 | 8,428 | 7,570 | 6,197 | 5,243 | 3,562 |
| Provisions for bad and doubtful debts | 2,736 | 1,428 | 1,461 | 1,286 | 984 | 550 |
| Amounts written off fixed asset investments | 159 | 83 | 33 | 59 | 7 | 42 |
| Profit on ordinary activities before tax | 13,253 | 6,917 | 6,076 | 4,852 | 4,252 | 2,970 |

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| | | | | | | |
|--|-------|-------|-------|-------|-------|-------|
| Tax on profit on ordinary activities | 4,129 | 2,155 | 1,888 | 1,582 | 1,537 | 1,054 |
| Profit on ordinary activities after tax | 9,124 | 4,762 | 4,188 | 3,270 | 2,715 | 1,916 |
| Minority interests (including non-equity) | 479 | 250 | 210 | 133 | 90 | 50 |
| Preference dividends non-equity | 490 | 256 | 261 | 305 | 358 | 294 |
| Additional Value Shares dividend non-equity | 8,155 | 4,256 | 3,717 | 2,832 | 2,267 | 1,572 |
| Profit attributable to ordinary shareholders | 8,155 | 4,256 | 2,254 | 2,034 | 1,868 | 1,572 |
| Amounts in accordance with US GAAP: | | | | | | |
| Net income available for ordinary shareholders | 7,564 | 3,948 | 2,564 | 3,108 | 2,062 | 2,102 |

Notes:

- (1) The years ended 31 December 2003 and 2002 have been restated following the implementation of FRS 17. It is not practicable to restate prior years.
- (2) Includes integration expenditure of £269 million for the year ended 31 December 2004 (2003 £229 million; 2002 £957 million; 2001 £875 million; 2000 £389 million).
- (3) Including goodwill amortisation of £915 million for the year ended 31 December 2004 (2003 £763 million; 2002 £731 million; 2001 £651 million; 2000 £537 million).

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Preference and other non-equity dividends

| Amount per share | 2004 \$m | 2004 £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|---|-------------|------------|------------|------------|------------|------------|
| Non-cumulative preference shares of US\$0.01 | | | | | | |
| Series B (1) | | | 0.13 | 1.65 | 1.73 | 1.67 |
| Series C (1) | | | 0.11 | 1.40 | 1.47 | 1.41 |
| Series D | 2.05 | 1.11 | 1.23 | 1.34 | 1.41 | 1.35 |
| Series E | 2.03 | 1.10 | 1.21 | 1.32 | 1.40 | 1.33 |
| Series F | 1.91 | 1.04 | 1.15 | 1.25 | 1.31 | 1.26 |
| Series G | 1.85 | 1.00 | 1.11 | 1.21 | 1.27 | 1.22 |
| Series H | 1.81 | 0.98 | 1.09 | 1.18 | 1.24 | 1.19 |
| Series I | 2.00 | 1.08 | 1.20 | 1.31 | 1.38 | 1.32 |
| Series J | 2.13 | 1.15 | 1.27 | 1.39 | 1.46 | 1.40 |
| Series K | 1.97 | 1.07 | 1.18 | 1.29 | 0.74 | |
| Series L | 0.37 | 0.19 | | | | |
| Series M | 0.57 | 0.30 | | | | |
| Non-cumulative convertible preference shares of US\$ 0.01 | | | | | | |
| Series 1 | 91.18 | 49.05 | 54.89 | 59.15 | 62.70 | 50.22 |
| Series 2 | 88.17 | 47.43 | 53.08 | 57.20 | 60.63 | 48.57 |

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| | | | | | | |
|--|--------|-------|-------|-------|-------|-------|
| Series 3 | 78.16 | 41.74 | 45.57 | 49.81 | 53.74 | 5.24 |
| Non-cumulative convertible preference shares of €0.01 | | | | | | |
| Series 1 | 84.67 | 44.19 | 49.58 | 44.45 | 41.34 | 34.55 |
| Non-cumulative preference shares of €0.01 | | | | | | |
| Series 1 | 6.61 | 3.45 | | | | |
| Non-cumulative convertible preference shares of £ 0.01 | | | | | | |
| Series 1 | 141.53 | 73.87 | 73.87 | 73.87 | 73.87 | 3.28 |
| Non-cumulative convertible preference shares of £0.25 | | | | | 0.08 | 0.07 |
| Additional Value Shares of £0.01 | | | 0.55 | 0.30 | 0.15 | |

Ordinary dividends

| Amount per share | 2004 cents | 2004 pence | 2003 pence | 2002 pence | 2001 pence | 2000 pence |
|---|--------------|-------------|-------------|-------------|-------------|-------------|
| Interim | 32.2 | 16.8 | 14.6 | 12.7 | 11.0 | 9.5 |
| Proposed final | 78.9 | 41.2 | 35.7 | 31.0 | 27.0 | 23.5 |
| Total dividends on equity shares | 111.1 | 58.0 | 50.3 | 43.7 | 38.0 | 33.0 |

Notes:

(1) Redeemed on 30 January 2003.

For further information, see Notes 6 and 7 on the accounts.

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Additional information continued

Summary consolidated balance sheet

| | 2004 \$m | 2004 £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|---|----------|---------|---------|---------|---------|---------|
| Amounts in accordance with UK GAAP (1) : | | | | | | |
| Loans and advances to banks (net of provisions) | 111,626 | 58,260 | 51,891 | 44,296 | 38,513 | 32,061 |
| Loans and advances to customers (net of provisions) | 661,918 | 345,469 | 252,531 | 223,324 | 190,492 | 168,076 |
| Debt securities and equity shares | 180,432 | 94,171 | 82,249 | 68,928 | 65,597 | 59,342 |
| Intangible fixed assets | 33,676 | 17,576 | 13,131 | 12,697 | 13,325 | 12,080 |
| Other assets | 130,271 | 67,991 | 54,626 | 61,793 | 60,932 | 48,510 |

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| | | | | | | |
|--|-----------|---------|---------|---------|---------|---------|
| Total assets | 1,117,923 | 583,467 | 454,428 | 411,038 | 368,859 | 320,069 |
| Called up share capital | 1,575 | 822 | 769 | 754 | 893 | 848 |
| Share premium account | 24,839 | 12,964 | 8,175 | 7,608 | 7,465 | 6,530 |
| Other reserves | 20,800 | 10,856 | 11,307 | 11,922 | 12,354 | 12,835 |
| Profit and loss account | 13,839 | 7,223 | 5,847 | 4,787 | 5,956 | 2,786 |
| Shareholders funds | 61,053 | 31,865 | 26,098 | 25,071 | 26,668 | 22,999 |
| Minority interests | 7,337 | 3,829 | 2,713 | 1,839 | 585 | 546 |
| Subordinated liabilities | 39,021 | 20,366 | 16,998 | 13,965 | 12,530 | 10,436 |
| Total capital resources | 107,411 | 56,060 | 45,809 | 40,875 | 39,783 | 33,981 |
| Deposits by banks | 189,839 | 99,081 | 67,323 | 54,720 | 40,038 | 35,130 |
| Customer accounts | 546,179 | 285,062 | 236,963 | 219,161 | 198,995 | 177,302 |
| Debt securities in issue | 112,967 | 58,960 | 41,016 | 33,938 | 30,669 | 19,407 |
| Other liabilities | 161,527 | 84,304 | 63,317 | 62,344 | 59,374 | 54,249 |
| Total liabilities | 1,117,923 | 583,467 | 454,428 | 411,038 | 368,859 | 320,069 |
| Amounts in accordance with US GAAP: | | | | | | |
| Shareholders equity | 69,342 | 36,191 | 31,665 | 28,177 | 29,088 | 25,423 |
| Total assets | 1,209,188 | 631,100 | 488,046 | 430,573 | 386,696 | 323,731 |

Notes:

- (1) The data as at 31 December 2003 and 2002 has been restated following the implementation of FRS 17. It is not practicable to restate prior years.

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Other financial data

| | 2004 | 2003 | 2002 | 2001 | 2000 |
|---|-------|-------|-------|-------|-------|
| Other financial data based upon UK GAAP (1): | | | | | |
| Earnings per ordinary share pence | 138.0 | 76.9 | 70.6 | 67.6 | 66.9 |
| Diluted earnings per ordinary share pence (2) | 136.9 | 76.3 | 69.6 | 66.3 | 66.2 |
| Dividends per ordinary share pence | 58.0 | 50.3 | 43.7 | 38.0 | 33.0 |
| Dividend payout ratio | 43.2% | 66.1% | 62.3% | 58.1% | 56.1% |
| Share price per ordinary share at period end £ | 17.52 | 16.46 | 14.88 | 16.72 | 15.82 |
| Market capitalisation at period end £bn | 55.6 | 48.8 | 43.2 | 47.8 | 42.4 |
| Net asset value per ordinary share £ | 8.62 | 7.82 | 7.43 | 7.79 | 7.08 |
| Return on average total assets (3) | 0.82% | 0.51% | 0.52% | 0.53% | 0.58% |
| Return on average equity shareholders funds (4) | 16.0% | 9.8% | 8.8% | 8.9% | 9.9% |

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| | | | | | |
|--|-------|-------|-------|-------|-------|
| Average shareholders' equity as a percentage of average total assets | 5.7% | 5.9% | 6.8% | 7.2% | 7.2% |
| Risk asset ratio Tier 1 | 7.0% | 7.4% | 7.3% | 7.1% | 6.9% |
| Total | 11.7% | 11.8% | 11.7% | 11.5% | 11.5% |
| Ratio of earnings to combined fixed charges and preference share dividends (5) | | | | | |
| including interest on deposits | 1.84 | 1.95 | 1.74 | 1.49 | 1.32 |
| excluding interest on deposits | 7.09 | 7.08 | 5.20 | 4.45 | 3.49 |
| Ratio of earnings to fixed charges only (5) | | | | | |
| including interest on deposits | 1.90 | 2.04 | 1.83 | 1.55 | 1.37 |
| excluding interest on deposits | 9.26 | 9.73 | 7.24 | 6.52 | 4.81 |
| Other financial data based upon US GAAP: | | | | | |
| Basic earnings per ordinary share pence | 128.0 | 87.5 | 107.9 | 74.7 | 89.5 |
| Diluted earnings per ordinary share pence (2) | 127.1 | 86.8 | 106.3 | 73.2 | 88.5 |
| Dividends per ordinary share pence | 52.5 | 45.6 | 39.7 | 34.5 | 29.8 |
| Dividend payout ratio | 40.2% | 51.9% | 36.7% | 45.7% | 20.6% |
| Return on average total assets (3) | 0.71% | 0.55% | 0.75% | 0.57% | 0.77% |
| Return on average equity shareholders' funds (4) | 12.8% | 9.5% | 12.1% | 8.8% | 12.0% |
| Average shareholders' equity as a percentage of average total assets | 6.1% | 6.5% | 7.3% | 7.7% | 7.7% |
| Ratio of earnings to combined fixed charges and preference share dividends (5) | | | | | |
| including interest on deposits | 1.76 | 1.98 | 1.97 | 1.51 | 1.41 |
| excluding interest on deposits | 6.46 | 7.24 | 6.49 | 4.63 | 4.19 |
| Ratio of earnings to fixed charges only (5) | | | | | |
| including interest on deposits | 1.81 | 2.07 | 2.07 | 1.59 | 1.46 |
| excluding interest on deposits | 8.44 | 9.96 | 9.03 | 6.98 | 5.77 |

Notes:

- (1) The years ended 31 December 2003 and 2002 have been restated following the implementation of FRS 17. It is not practicable to restate prior years.
- (2) Convertible preference shares totalling nil (2003 and 2002 £200 million; 2001 and 2000 £800 million), nil (2003, 2002, 2001 and 2000 €750 million) and \$1,500 million (2003, 2002, 2001 and 2000 \$1,900 million) have not been included in the computation of diluted earnings per share as their effect is anti-dilutive.
- (3) Return on average total assets represents profit attributable to ordinary shareholders as a percentage of average total assets.
- (4) Return on average equity shareholders' funds represents profit attributable to ordinary shareholders expressed as a percentage of average equity shareholders' funds.
- (5) For this purpose, earnings consist of income before tax and minority 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).

Analysis of loans and advances to customers

The following table analyses loans and advances to customers before provisions by remaining maturity, geographical area and type of customer. Overdrafts are included in the 'Within 1 year' category.

| | Within 1 year £m | After 1 but within 5 years £m | After 5 years £m | 2004 Total £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|--|------------------------|---|------------------------|---------------------|----------------|----------------|----------------|----------------|
| UK | | | | | | | | |
| Central and local government | 1,670 | 95 | 101 | 1,866 | 1,217 | 1,521 | 706 | 1,957 |
| Manufacturing | 5,073 | 639 | 580 | 6,292 | 6,384 | 7,386 | 7,401 | 6,806 |
| Construction | 3,726 | 676 | 622 | 5,024 | 3,960 | 3,468 | 3,018 | 2,615 |
| Finance | 23,617 | 1,021 | 519 | 25,157 | 18,948 | 12,396 | 8,517 | 9,944 |
| Service industries and business activities | 18,620 | 5,317 | 6,913 | 30,850 | 29,290 | 26,022 | 25,033 | 20,903 |
| Agriculture, forestry and fishing | 913 | 898 | 669 | 2,480 | 2,562 | 2,463 | 2,391 | 2,373 |
| Property | 19,794 | 2,673 | 3,978 | 26,445 | 19,670 | 15,939 | 12,274 | 10,415 |
| Individuals home mortgages | 1,736 | 4,955 | 50,838 | 57,529 | 48,117 | 42,101 | 36,976 | 32,600 |
| Individuals other | 14,072 | 7,965 | 5,826 | 27,863 | 25,526 | 22,255 | 20,076 | 17,881 |
| Finance leases and instalment credit | 2,534 | 4,506 | 6,043 | 13,083 | 11,703 | 11,723 | 11,258 | 10,816 |
| Total domestic | 91,755 | 28,745 | 76,089 | 196,589 | 167,377 | 145,274 | 127,650 | 116,310 |
| Overseas residents | 41,049 | 942 | 2,062 | 44,053 | 27,168 | 23,657 | 24,164 | 19,257 |
| Total UK offices | 132,804 | 29,687 | 78,151 | 240,642 | 194,545 | 168,931 | 151,814 | 135,567 |
| Overseas | | | | | | | | |
| US | 32,518 | 16,624 | 24,903 | 74,045 | 40,373 | 41,008 | 29,230 | 23,050 |
| Rest of the World | 14,157 | 7,232 | 13,615 | 35,004 | 21,535 | 17,305 | 13,093 | 12,598 |
| Total overseas offices | 46,675 | 23,856 | 38,518 | 109,049 | 61,908 | 58,313 | 42,323 | 35,648 |
| Loans and advances to customers gross | | | | | | | | |
| | 179,479 | 53,543 | 116,669 | 349,691 | 256,453 | 227,244 | 194,137 | 171,215 |
| Provisions for bad and doubtful debts | | | | (4,222) | (3,922) | (3,920) | (3,645) | (3,139) |
| Loans and advances to customers net | | | | | | | | |
| | | | | 345,469 | 252,531 | 223,324 | 190,492 | 168,076 |
| Fixed rate | 36,895 | 23,491 | 40,343 | 100,729 | 81,918 | 80,326 | 62,282 | 53,983 |
| Variable rate | 142,584 | 30,052 | 76,236 | 248,962 | 174,535 | 146,918 | 131,855 | 117,232 |
| Gross loans and advances to customers by maturity | 179,479 | 53,543 | 116,669 | 349,691 | 256,453 | 227,244 | 194,137 | 171,215 |

Provisions for bad and doubtful debts

For a discussion of the factors considered in determining the amount of the provisions, see [Provisions](#) on page 47 and [Critical accounting policies - Provisions for bad and doubtful debts](#) on page 7.

The following table shows the elements of provisions for bad and doubtful debts.

| | 2004 £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|---|------------|------------|------------|------------|------------|
| Provisions at the beginning of the period | | | | | |
| Domestic | 2,452 | 2,581 | 2,467 | 2,370 | 484 |
| Foreign | 1,477 | 1,346 | 1,186 | 783 | 332 |
| | 3,929 | 3,927 | 3,653 | 3,153 | 816 |
| Currency translation and other adjustments | | | | | |
| Domestic | (8) | (2) | (4) | 4 | (1) |
| Foreign | (90) | (60) | (58) | 13 | 43 |
| | (98) | (62) | (62) | 17 | 42 |
| Acquisitions of businesses | | | | | |
| Domestic | 2 | | 11 | 83 | 1,871 |
| Foreign | 288 | 50 | 12 | 171 | 494 |
| | 290 | 50 | 23 | 254 | 2,365 |
| Amounts written-off | | | | | |
| Domestic | (920) | (1,097) | (743) | (645) | (599) |
| Foreign | (548) | (422) | (293) | (190) | (185) |
| | (1,468) | (1,519) | (1,036) | (835) | (784) |
| Recoveries of amounts written-off in previous periods | | | | | |
| Domestic | 88 | 38 | 37 | 54 | 142 |
| Foreign | 59 | 34 | 26 | 26 | 22 |
| | 147 | 72 | 63 | 80 | 164 |

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| | | | | | |
|---|---------|---------|---------|---------|---------|
| Charged to profit and loss account | | | | | |
| Domestic | 986 | 932 | 813 | 601 | 473 |
| Foreign | 442 | 529 | 473 | 383 | 77 |
| | 1,428 | 1,461 | 1,286 | 984 | 550 |
| Provisions at the end of the period (1) | | | | | |
| Domestic | 2,600 | 2,452 | 2,581 | 2,467 | 2,370 |
| Foreign | 1,628 | 1,477 | 1,346 | 1,186 | 783 |
| | 4,228 | 3,929 | 3,927 | 3,653 | 3,153 |
| Gross loans and advances to customers | | | | | |
| Domestic | 196,588 | 167,377 | 145,274 | 127,650 | 116,310 |
| Foreign | 153,103 | 89,076 | 81,970 | 66,487 | 54,905 |
| | 349,691 | 256,453 | 227,244 | 194,137 | 171,215 |
| Closing customer provisions as a % of gross loans and advances to customers (2) | | | | | |
| Domestic | 1.32% | 1.46% | 1.78% | 1.93% | 2.04% |
| Foreign | 1.06% | 1.65% | 1.63% | 1.77% | 1.40% |
| Total | 1.21% | 1.53% | 1.72% | 1.88% | 1.83% |
| Customer charge against profit as a % of gross loans and advances to customers | | | | | |
| Domestic | 0.50% | 0.56% | 0.56% | 0.47% | 0.41% |
| Foreign | 0.29% | 0.59% | 0.58% | 0.58% | 0.14% |
| Total | 0.41% | 0.57% | 0.57% | 0.51% | 0.32% |

Notes:

(1) Includes closing provisions against loans and advances to banks of £6 million (2003 £7 million; 2002 £7 million; 2001 £8 million; 2000 £14 million).

(2) Closing customer provisions exclude closing provisions against loans and advances to banks.

Provisions for bad and doubtful debts (continued)

The following table presents additional information with respect to the provisions for bad and doubtful debts.

| | 2004 £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|---|------------|------------|------------|------------|------------|
| Loans and advances to customers (gross) | 349,691 | 256,453 | 227,244 | 194,137 | 171,215 |
| Provisions at end of period: | | | | | |
| Specific provisions customers | 3,648 | 3,356 | 3,323 | 3,031 | 2,571 |
| banks | 6 | 7 | 7 | 8 | 14 |
| General provision | 574 | 566 | 597 | 614 | 568 |
| | 4,228 | 3,929 | 3,927 | 3,653 | 3,153 |
| Customer provision at end of period as % of loans and advances to customers at end of period: | | | | | |
| Specific provisions | 1.04% | 1.31% | 1.46% | 1.56% | 1.50% |
| General provision | 0.17% | 0.22% | 0.26% | 0.32% | 0.33% |
| | 1.21% | 1.53% | 1.72% | 1.88% | 1.83% |
| Average loans and advances to customers (gross) | 298,150 | 245,798 | 211,206 | 181,584 | 142,288 |
| As a % of average loans and advances to customers during the period: | | | | | |
| Total customer provisions charged to profit and loss | 0.48% | 0.59% | 0.61% | 0.54% | 0.39% |
| Amounts written-off (net of recoveries) customers | 0.44% | 0.59% | 0.46% | 0.42% | 0.44% |

Analysis of closing provisions for bad and doubtful debts

The following table analyses customer provisions for bad and doubtful debts by geographical area and type of domestic customer.

| | 2004 | | 2003 | | 2002 | | 2001 | | 2000 | |
|------------------------------|-------------------------|------------------|-------------------------|------------------|-------------------------|------------------|-------------------------|------------------|-------------------------|------------------|
| | Closing provision £m | % of total loans | Closing provision £m | % of total loans | Closing provision £m | % of total loans | Closing provision £m | % of total loans | Closing provision £m | % of total loans |
| Domestic | | | | | | | | | | |
| Central and local government | | 0.5 | | 0.5 | | 0.6 | | 0.4 | | 1.1 |
| Manufacturing | 127 | 1.8 | 156 | 2.5 | 205 | 3.2 | 209 | 3.8 | 148 | 4.0 |

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| | | | | | | | | | | |
|--|--------------|-------------|--------------|-------------|--------------|-------------|--------------|-------------|--------------|-------------|
| Construction | 71 | 1.4 | 56 | 1.5 | 65 | 1.5 | 72 | 1.6 | 77 | 1.5 |
| Finance | 54 | 7.2 | 34 | 7.4 | 71 | 5.5 | 73 | 4.4 | 75 | 5.8 |
| Service industries and business activities | 516 | 8.8 | 599 | 11.4 | 699 | 11.5 | 627 | 12.9 | 665 | 12.2 |
| Agriculture, forestry and fishing | 23 | 0.7 | 20 | 1.0 | 29 | 1.1 | 31 | 1.2 | 33 | 1.4 |
| Property | 64 | 7.6 | 58 | 7.7 | 40 | 7.0 | 39 | 6.3 | 55 | 6.1 |
| Individuals home mortgages | 32 | 16.5 | 35 | 18.8 | 60 | 18.5 | 53 | 19.1 | 35 | 19.0 |
| other | 1,318 | 8.0 | 1,003 | 9.9 | 855 | 9.8 | 855 | 10.3 | 797 | 10.5 |
| Finance leases and instalment credit | 122 | 3.7 | 136 | 4.6 | 208 | 5.2 | 164 | 5.8 | 149 | 6.3 |
| Total domestic | 2,327 | 56.2 | 2,097 | 65.3 | 2,232 | 63.9 | 2,123 | 65.8 | 2,034 | 67.9 |
| Foreign | 1,321 | 43.8 | 1,259 | 34.7 | 1,091 | 36.1 | 908 | 34.2 | 537 | 32.1 |
| Specific provisions | 3,648 | 100.0 | 3,356 | 100.0 | 3,323 | 100.0 | 3,031 | 100.0 | 2,571 | 100.0 |
| General provision | 574 | | 566 | | 597 | | 614 | | 568 | |
| Total provisions | 4,222 | | 3,922 | | 3,920 | | 3,645 | | 3,139 | |

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Analysis of write-offs

The following table analyses amounts written-off by geographical area and type of domestic customer.

| | 2004 £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|--|--------------|--------------|--------------|------------|------------|
| Domestic | | | | | |
| Manufacturing | 55 | 99 | 111 | 61 | 55 |
| Construction | 12 | 22 | 18 | 19 | 30 |
| Finance | 19 | 54 | 35 | 8 | 5 |
| Service industries and business activities | 163 | 393 | 180 | 176 | 146 |
| Agriculture, forestry and fishing | 9 | 4 | 10 | 5 | 5 |
| Property | 33 | 6 | 9 | 14 | 7 |
| Individuals home mortgages | 4 | 2 | 2 | 3 | 12 |
| others | 535 | 357 | 333 | 297 | 230 |
| Finance leases and instalment credit | 90 | 160 | 45 | 62 | 109 |
| Total domestic | 920 | 1,097 | 743 | 645 | 599 |
| Foreign | 548 | 422 | 293 | 190 | 185 |
| Total write-offs* | 1,468 | 1,519 | 1,036 | 835 | 784 |

* Includes amounts written-off in respect of banks of nil (2003 nil; 2002 £1 million; 2001 £6 million; 2000 £5 million).

Analysis of recoveries

The following table analyses recoveries of amounts written-off by geographical area and type of domestic customer.

| | 2004 £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|--|------------|------------|------------|------------|------------|
| Domestic | | | | | |
| Manufacturing | 1 | | 1 | 2 | 12 |
| Construction | | | | 1 | 13 |
| Finance | 2 | | | 1 | 3 |
| Service industries and business activities | 1 | 3 | 1 | 5 | 45 |
| Agriculture, forestry and fishing | | | | | 3 |
| Property | | | 1 | 1 | 6 |
| Individuals home mortgages | 1 | | | | |
| others | 81 | 26 | 27 | 41 | 57 |
| Finance leases and instalment credit | 2 | 9 | 7 | 3 | 3 |
| Total domestic | 88 | 38 | 37 | 54 | 142 |
| Foreign | 59 | 34 | 26 | 26 | 22 |
| Total recoveries | 147 | 72 | 63 | 80 | 164 |

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Additional information (continued)

Risk elements in lending and potential problem loans

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

| | 2004 £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|---|--------------|--------------|--------------|--------------|--------------|
| Loans accounted for on a non-accrual basis (3): | | | | | |
| Domestic | 3,705 | 3,221 | 3,077 | 2,829 | 2,482 |
| Foreign | 1,075 | 1,211 | 1,098 | 737 | 344 |
| Total | 4,780 | 4,432 | 4,175 | 3,566 | 2,826 |

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| | | | | | |
|--|--------------|--------------|--------------|--------------|--------------|
| Accruing loans which are contractually overdue 90 days or more as to principal or interest (4): | | | | | |
| Domestic | 646 | 561 | 363 | 643 | 662 |
| Foreign | 79 | 81 | 129 | 142 | 168 |
| Total | 725 | 642 | 492 | 785 | 830 |
| Loans not included above which are classified as troubled debt restructurings by the SEC: | | | | | |
| Domestic | 14 | 53 | 144 | 26 | 43 |
| Foreign | 10 | 30 | 60 | 116 | 122 |
| Total | 24 | 83 | 204 | 142 | 165 |
| Total risk elements in lending | 5,529 | 5,157 | 4,871 | 4,493 | 3,821 |
| Potential problem loans (5) | | | | | |
| Domestic | 173 | 492 | 639 | 801 | 699 |
| Foreign | 107 | 99 | 544 | 279 | 73 |
| Total potential problem loans | 280 | 591 | 1,183 | 1,080 | 772 |
| Closing provisions for bad and doubtful debts as a % of total risk elements in lending | | | | | |
| | 76% | 76% | 80% | 81% | 82% |
| Closing provisions for bad and doubtful debts as a % of total risk elements in lending and potential problem loans | | | | | |
| | 73% | 68% | 65% | 65% | 68% |
| Risk elements in lending as a % of gross loans and advances to customers | | | | | |
| | 1.58% | 2.01% | 2.14% | 2.31% | 2.23% |

Notes:

- (1) For the analysis above, Domestic consists of the UK domestic transactions of the Group. Foreign comprises the Group's transactions conducted through offices outside the UK and through those offices in the UK specifically organised to service international banking transactions.
- (2) The classification of a loan as non-accrual, past due 90 days or troubled debt restructuring does not necessarily indicate that the principal of the loan is uncollectable in whole or in part. Collection depends in each case on the individual circumstances of the loan, including the adequacy of any collateral securing the loan and therefore classification of a loan as non-accrual, past due 90 days or troubled debt restructuring does not always require that a provision be made against such a loan. In accordance with the Group's provisioning policy for bad and doubtful debts, it is considered that adequate provisions for the above risk elements in lending have been made.
- (3) The Group's UK banking subsidiary undertakings account for loans on a non-accrual basis from the point in time at which the collectability of interest is in significant doubt. Certain subsidiary undertakings of the Group, principally Citizens, generally account for loans on a non-accrual basis when interest or principal is past due 90 days.
- (4) Overdrafts generally have no fixed repayment schedule and consequently are not included in this category.
- (5) Loans that are current as to the payment of principal and interest but in respect of which management has serious doubts about the ability of the borrower to comply with contractual repayment terms. Substantial security is held in respect of these loans and appropriate provisions have already been made in accordance with the Group's provisioning policy for bad and doubtful debts.

| | 2004 £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|---|------------|------------|------------|------------|------------|
| Gross income not recognised but which would have been recognised under the original terms of non-accrual and restructured loans | | | | | |
| Domestic | 237 | 237 | 234 | 173 | 148 |

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| | | | | | |
|--|-----|-----|-----|-----|-----|
| Foreign | 58 | 55 | 73 | 60 | 48 |
| | 295 | 292 | 307 | 233 | 196 |
| Interest on non-accrual and restructured loans included in net interest income | | | | | |
| Domestic | 58 | 60 | 47 | 42 | 30 |
| Foreign | 7 | 3 | 7 | 14 | 8 |
| | 65 | 63 | 54 | 56 | 38 |

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Analysis of deposits product analysis

The following table shows the distribution of the Group's deposits by type and geographical area:

| | 2004 £m | 2003 £m | 2002 £m |
|---|----------------|----------------|----------------|
| UK | | | |
| Domestic: | | | |
| Demand deposits interest-free | 22,249 | 20,567 | 22,067 |
| interest-bearing | 78,178 | 78,670 | 66,118 |
| Time deposits savings | 18,205 | 13,238 | 12,180 |
| other | 68,662 | 57,994 | 59,819 |
| Overseas residents: | | | |
| Demand deposits interest-free | 376 | 830 | 908 |
| interest-bearing | 12,740 | 9,559 | 8,897 |
| Time deposits savings | 836 | 1,014 | 1,559 |
| other | 64,141 | 32,531 | 21,824 |
| Total UK offices | 265,387 | 214,403 | 193,372 |
| Overseas | | | |
| Demand deposits interest-free | 10,371 | 7,937 | 6,698 |
| interest-bearing | 12,975 | 7,471 | 10,148 |
| Time deposits savings | 21,153 | 15,450 | 15,189 |
| other | 74,257 | 59,025 | 48,474 |
| Total overseas offices (see below) | 118,756 | 89,883 | 80,509 |

| | | | |
|-----------------------|---------|---------|---------|
| Total deposits | 384,143 | 304,286 | 273,881 |
| Banking business | 303,328 | 251,986 | 230,144 |
| Trading business | 80,815 | 52,300 | 43,737 |
| Total deposits | 384,143 | 304,286 | 273,881 |
| Overseas | | | |
| US | 86,677 | 67,019 | 61,738 |
| Rest of the World | 32,079 | 22,864 | 18,771 |
| Total overseas | 118,756 | 89,883 | 80,509 |

Analysis of deposits – currency analysis

The following table shows the distribution of deposits by banks and customer accounts by sterling and other currencies:

| | 2004 £m | 2003 £m | 2002 £m |
|--------------------------------|------------|------------|------------|
| Deposits by banks | | | |
| Sterling | 18,958 | 14,574 | 10,998 |
| Other currencies | 80,123 | 52,749 | 43,722 |
| Total deposits by banks | 99,081 | 67,323 | 54,720 |
| Customer accounts | | | |
| Sterling | 161,636 | 142,551 | 133,404 |
| Other currencies | 123,426 | 94,412 | 85,757 |
| Total customer accounts | 285,062 | 236,963 | 219,161 |
| Total deposits | 384,143 | 304,286 | 273,881 |

Additional information continued**Short term borrowings**

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| | 2004 £m | 2003 £m | 2002 £m |
|--|------------|------------|------------|
| Commercial paper | | | |
| Outstanding at year end | 8,391 | 6,968 | 3,515 |
| Maximum outstanding at any month end during the year | 8,391 | 7,032 | 3,515 |
| Approximate average amount during the year | 7,450 | 5,499 | 868 |
| Approximate weighted average interest rate during the year | 1.9% | 1.6% | 2.0% |
| Approximate weighted average interest rate at year end | 2.6% | 1.5% | 1.6% |
| Other short term borrowings | | | |
| Outstanding at year end | 95,381 | 84,795 | 72,069 |
| Maximum outstanding at any month end during the year | 96,356 | 94,570 | 72,264 |
| Approximate average amount during the year | 85,496 | 78,004 | 58,246 |
| Approximate weighted average interest rate during the year | 2.9% | 2.2% | 2.9% |
| Approximate weighted average interest rate at year end | 3.1% | 2.0% | 2.2% |

Average interest rates during the year are computed by dividing total interest expense by the average amount borrowed. Average interest rates at year end are average rates for a single day and as such may reflect one-day market distortions which may not be indicative of generally prevailing rates. Original maturities of commercial paper are not in excess of one year. Other short-term borrowings consist principally of borrowings in the money markets included within Deposits by banks and Customer accounts in the accounts, and generally have original maturities of one year or less.

Certificates of deposit and other time deposits

The following table shows details of the Group's certificates of deposit and other time deposits over \$100,000 or equivalent by remaining maturity.

| | Within 3 months £m | Over 3 months but within 6 months £m | Over 6 months but within 12 months £m | Over 12 months £m | 2004 Total £m |
|--|--------------------------|--|---|----------------------------|---------------------|
| UK based companies and branches | | | | | |
| Certificates of deposit | 18,574 | 3,071 | 1,837 | 66 | 23,548 |
| Other time deposits | 116,623 | 6,468 | 6,051 | 3,224 | 132,366 |
| Overseas based companies and branches | | | | | |
| Certificates of deposit | 6,703 | 2,674 | 1,719 | 1,594 | 12,690 |
| Other time deposits | 44,260 | 4,209 | 2,007 | 6,226 | 56,702 |
| Total | 186,160 | 16,422 | 11,614 | 11,110 | 225,306 |

Exchange rates

Except as stated, the following tables show, for the dates or periods indicated, the Noon Buying Rate in New York for cable transfers in sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate):

| US dollars per £1 | February 2005 | January 2005 | December 2004 | November 2004 | October 2004 | September 2004 |
|-------------------|------------------|-----------------|------------------|------------------|-----------------|-------------------|
| Noon Buying Rate | | | | | | |
| High | 1.9249 | 1.9058 | 1.9482 | 1,9073 | 1.8404 | 1.8105 |
| Low | 1.8570 | 1.8647 | 1.9125 | 1,8323 | 1.7790 | 1.7733 |

| | 2004 | 2003 | 2002 | 2001 | 2000 |
|---------------------------------|--------|--------|--------|--------|--------|
| Noon Buying Rate | | | | | |
| Period end rate | 1.9160 | 1.7842 | 1.6095 | 1.4543 | 1.4955 |
| Average rate for the period (1) | 1.8356 | 1.6450 | 1.5043 | 1.4396 | 1.5204 |
| Consolidation rate (2) | | | | | |
| Period end rate | 1.9346 | 1.7857 | 1.6128 | 1.4498 | 1.4925 |
| Average rate for the period | 1.8325 | 1.6354 | 1.5032 | 1.4401 | 1.5160 |

Notes:

- (1) The average of the Noon Buying Rates on the last business day of each month during the period.
- (2) The rates used by the Group for translating dollars into sterling in the preparation of its financial statements.
- (3) On 29 March 2005, the Noon Buying Rate was £1.00 = \$1.8752.

Additional information continued**Off balance sheet arrangements**

The Group is involved with several types of off-balance sheet arrangements, including special purpose vehicles, lending commitments and financial guarantees.

Special purpose vehicles (SPVs)

SPVs are vehicles set up for a specific, limited purpose, do not carry out a business or trade and typically have no employees. They take a variety of legal forms trusts, partnerships and companies and fulfil many different functions. They constitute a key element of securitisation transactions in which an SPV acquires financial assets funded by the issue of securities.

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In the normal course of business, the Group arranges securitisations to facilitate client transactions and undertakes securitisations to sell financial assets or to obtain funding. It has established a number of SPVs to act as commercial paper conduits for customers. SPVs are also utilised in its fund management activities to structure investment funds to which the Group provides investment management services.

Under UK GAAP, the Group accounts for securitisations of assets originated by the Group in accordance with FRS 5 *Reporting the Substance of Transactions*. Assets are derecognised and a gain or loss on disposal recognised if all significant rights or access to benefits relating to those assets and all significant risks in those benefits are transferred to others. In cases where there is a significant change in the entity's rights to benefit and exposure to risk, the description or monetary amount relating to an asset should be changed and a liability recognised for any obligation to transfer benefits that is assumed. Where a transaction in previously recognised assets results in no significant change in the entity's rights to benefits in the assets or its exposure to risks inherent in those benefits, the assets should continue to be recognised and no gain or loss recognised. FRS 5 requires a linked presentation where a transaction is in substance the financing of an asset or pool of assets but where the item is financed in such a way that the Group can suffer a loss which is limited to a fixed monetary amount. The linked presentation involves showing the gross amount of assets securitised less the related finance on the face of the balance sheet – the net amount is included in total assets. Profit is recognised on entering into the arrangement only to the extent that non-returnable proceeds exceed the previous carrying value of the assets securitised. The Group securitises mortgage loans and other assets.

Under US GAAP, transfers of financial assets are accounted for and reported based on the application of a financial-components approach that focuses on control. Under this approach, after a transfer of financial assets, the Group recognises the assets it controls and the liabilities it has incurred, derecognises financial assets when control has been surrendered, and derecognises liabilities when extinguished.

Transfers of financial assets where the Group has surrendered control over the transferred assets are accounted for as sales and any gain or loss recognised in earnings. Otherwise, transfers are accounted for as collateralised borrowings.

As financial intermediary, the Group arranges securitisations of client assets. These include multi-seller commercial paper conduits and client intermediation transactions. The Group has established a number of SPVs to act as commercial paper conduits. These allow customers to access liquidity in the commercial paper market by selling assets to the conduit that funds the purchase by issuing commercial paper to third parties. The Group supplies certain services and contingent liquidity support to some or all of these vehicles on an arm's length basis as well as programme credit enhancement. Other client securitisations arranged by the Group involve individual SPVs established to purchase customer assets financed by the issue of debt obligations to third parties. The Group may act as advisor to the manager of the SPV and provide liquidity facilities to it.

Under UK GAAP the Group accounts for fees received from client securitisations in line with its usual policy for similar fees from other banking activities. Undrawn liquidity lines are included within undrawn commitments in Note 41 on page 124; any drawn amounts will be included in loans and advances. The assets and liabilities of the SPVs are not recognised on the Group's balance sheet unless the SPV is a quasi-subsiary of the Group. A quasi-subsiary is defined in FRS 5 as a company, trust, partnership or other vehicle, that, though not fulfilling the definition of a subsidiary, is directly or indirectly controlled by the reporting entity and gives rise to benefits for that entity that are in substance no different from those that would arise were the vehicle a subsidiary.

Following the issue of FASB Interpretation (FIN) No. 46 (revised), the Group has consolidated SPVs acting as commercial paper conduits and involved in other asset-backed transactions in its US GAAP disclosures. Further information on FIN 46R can be found in Note 53 on page 145.

Lending commitments and other commitments

Under a loan commitment, the Group agrees to make funds available to a customer in the future. Loan commitments, which are usually for a specified term, may be unconditionally cancellable or may persist, provided all conditions in the loan facility are satisfied or waived. Commitments to lend include commercial standby facilities and credit lines, liquidity facilities to commercial paper conduits and unutilised overdraft facilities. Other commitments include documentary credits, which are commercial letters of credit providing for payment by the Group to a named beneficiary against presentation of specified documents, forward asset purchases, forward deposits placed and undrawn note issuance and revolving underwriting facilities.

Guarantees and other contingent liabilities

The Group gives guarantees on behalf of customers. A financial guarantee represents an irrevocable undertaking that the Group will meet a customer's obligations to third parties if the customer fails to do so. The maximum amount that the Group could be required to pay under a guarantee is its principal amount. The Group expects most guarantees it provides to expire unused. Other contingent liabilities include contingent liabilities arising out of acceptances, endorsements,

standby letters of credit, performance and customs bonds, warranties and indemnities. In accepting a bill of exchange drawn on it by a customer a bank undertakes to pay the holder of the bill at maturity. Most acceptances are presented for payment and reimbursement by the customer is usually immediate. In the UK, bills accepted by certain banks designated by the Bank of England are eligible for rediscount at the Bank of England. In endorsing a bill of exchange, a bank accepts liability for payment of any shortfall on the bill at maturity. Unlike acceptances, the endorsing bank receives value for the bill, which is then rediscounted.

The Group's contingent liabilities and commitments are set out below.

| | Less than 1 year £m | More than 1 year but | More than 3 years but | Over 5 years £m | Total £m |
|---|---------------------------|-------------------------------|--------------------------------|-----------------------|----------------|
| | | less than 3 years £m | less than 5 years £m | | |
| 2004 | | | | | |
| Acceptances and endorsements | 362 | | | | 362 |
| Guarantees and assets pledged as collateral security | 3,974 | 1,729 | 1,893 | 2,842 | 10,438 |
| Other contingent liabilities | 2,714 | 785 | 293 | 1,501 | 5,293 |
| Documentary credits and trade related transactions | 135 | 30 | 6 | 11 | 182 |
| Undrawn formal standby facilities, credit lines and other commitments to lend | 118,367 | 23,045 | 21,216 | 16,602 | 179,230 |
| Other commitments | 746 | 385 | | 234 | 1,365 |
| Total | 126,298 | 25,974 | 23,408 | 21,190 | 196,870 |
| | | | | | |
| | Less than 1 year £m | More than 1 year but | More than 3 years but | Over 5 years £m | Total £m |
| | | less than 3 years £m | less than 5 years £m | | |
| 2003 | | | | | |
| Acceptances and endorsements | 595 | | | | 595 |
| Guarantees and assets pledged as collateral security | 4,632 | 1,422 | 782 | 1,951 | 8,787 |
| Other contingent liabilities | 1,872 | 987 | 351 | 2,272 | 5,482 |
| Documentary credits and trade related transactions | 368 | 210 | 2 | 25 | 605 |
| Undrawn formal standby facilities, credit lines and other commitments to lend | 95,062 | 18,082 | 14,053 | 10,054 | 137,251 |
| Other commitments | 1,304 | 476 | 15 | 42 | 1,837 |
| Total | 103,833 | 21,177 | 15,203 | 14,344 | 154,557 |

Contractual obligations

The table below summarises the Group's contractual cash obligations by remaining maturity.

| | Less than | More than 1 year but less than 3 years | More than 3 years but less than 5 years | Over 5 years | Total |
|---|--------------|--|---|-----------------|---------------|
| | 1 year | 3 years | 5 years | 5 years | |
| 2004 | £m | £m | £m | £m | £m |
| Contractual cash obligations | | | | | |
| Dated loan capital | 371 | 527 | 2,863 | 7,252 | 11,013 |
| Operating leases | 328 | 597 | 535 | 2,246 | 3,706 |
| Finance leases | 17 | 38 | 11 | 126 | 192 |
| Unconditional obligations to purchase goods or services | 552 | 346 | 148 | 152 | 1,198 |
| Total | 1,268 | 1,508 | 3,557 | 9,776 | 16,109 |

| | Less than | More than 1 year but less than 3 years | More than 3 years but less than 5 years | Over 5 years | Total |
|---|--------------|--|---|-----------------|---------------|
| | 1 year | 3 years | 5 years | 5 years | |
| 2003 | £m | £m | £m | £m | £m |
| Contractual cash obligations | | | | | |
| Dated loan capital | 709 | 691 | 1,034 | 6,878 | 9,312 |
| Operating leases | 262 | 479 | 434 | 2,124 | 3,299 |
| Finance leases | 19 | 29 | 8 | 126 | 182 |
| Unconditional obligations to purchase goods or services | 661 | 211 | 3 | | 875 |
| Total | 1,651 | 1,410 | 1,479 | 9,128 | 13,668 |

The tables above do not include undated loan capital. The maturity of deposits by banks is given in Note 23 on the accounts, of customer accounts in Note 24, and of debt securities in issue in Note 25.

Economic and monetary environment

Monetary policy

The Group's earnings are affected by domestic and global economic conditions. The policies of the UK government, and of governments in other countries in which the Group operates, also have an impact.

The UK government sets an inflation target, which changed in December 2003 from a 2.5% target based on the retail prices index excluding mortgage interest payments to a 2% target based on the consumer prices index, in line with other European countries.

The Bank of England has operational independence in setting the repo rate to achieve the inflation target. The Bank was given independence by the Chancellor of the Exchequer in 1997, with the aim of making monetary policy free from political influence, and therefore more stable and credible. The Bank's Monetary Policy Committee ("MPC") meets each month to agree any change to interest rates, and the minutes of these meetings are published two weeks later. One-off meetings can also be held in exceptional circumstances. In response to the downturn in the global economy and the terrorist attacks, the Bank of England, along with other major central banks around the world, cut rates sharply in 2001. Rates remained at exceptionally low levels throughout 2002, and were reduced again in the first half of 2003, reflecting the uncertain nature of the global and domestic economic circumstances. However, signs of recovery in the global economy led the Bank of England to increase rates five times since November 2003, to 4.75%.

The value of sterling is also important for UK monetary conditions. The monetary authorities do not have an exchange rate target, but movements in sterling played a role in the MPC's monthly debates.

European Economic and Monetary Union (EMU)

The new European single currency, the euro, came into being on 1 January 1999. The third stage of EMU started on schedule on 1 January 1999. During the course of 1998, it was determined that eleven countries (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain) would participate. The UK, along with Denmark, exercised its right to opt out at that stage, and Sweden also determined not to be part of this first wave.

On 31 December 1998, the European Currency Unit (the "ECU") was replaced by the euro on the international currency markets, on a one-for-one basis. The rates for the euro against other international currencies were based upon the official closing rates for the ECU. The bilateral rates for the legacy currencies of the participating states were derived from their rates within the Exchange Rate Mechanism and the closing value of the ECU. These rates, between the legacy currencies and between these currencies and the euro, were fixed as of 1 January 1999. The euro became the formal currency for all eleven then-participating states.

Euro notes and coins were introduced into circulation on 1 January 2002 in accordance with the Maastricht Treaty, which required that legacy currency notes and coins be withdrawn by 30 June 2002. Also on 1 January 1999, the European Central Bank ("ECB") assumed responsibility for the operation of monetary policy throughout the euro zone. The ECB sets one short-term interest rate to cover all twelve countries.

The UK government continues to support EMU entry in principle, but has decided the UK will not adopt the single currency until it is in the UK's economic interests, with a positive referendum vote. The Chancellor of the Exchequer has laid down five key economic conditions for UK participation. An assessment of these five tests took place in June 2003, resulting in the publication of HM Treasury's assessment, the 18 supporting EMU studies, and a third outline National Changeover Plan. While indicating that these five economic tests have yet to be fully met, the government has set out a programme of economic reforms and structural assessments necessary to achieve readiness for entry. The Chancellor made a progress statement in Budget 2004, at which point he decided not to undertake an immediate further assessment of the entry tests.

The Group continues to co-operate with the UK government, and to work within the financial services sector, to develop thinking and plans regarding a range of practical issues that would arise if the UK were to decide to enter EMU. In particular, the Group continues its involvement in discussions as to how a phased transition could be achieved, in order to minimise cost and risk. In addition, due attention is being paid to the implications, for elements of the Group and for customers, of the introduction of euro notes and coins and the withdrawal of sterling.

Uncertainty continues on the likelihood and timing of the euro being introduced in the UK. It is not possible to estimate with any degree of certainty the ultimate cost of making systems and operations fully compliant. Expenditure in the year ended 31 December 2004 in preparation for the possible introduction of the euro in the UK was minimal.

Supervision and regulation

1 United Kingdom

1.1 *The regulatory regime applying to the UK financial services industry*

The Financial Services and Markets Act 2000 (FSMA 2000), containing an integrated legislative framework for regulating most of the UK financial services industry, came into force at the end of 2001. This established the Financial Services Authority (the FSA) as the single statutory regulator responsible for regulating deposit taking, insurance and investment business in the UK.

Under the FSMA 2000, businesses require the FSA s permission to undertake specified types of activities including entering into and carrying out contracts of insurance; managing, dealing in or advising on, investments; accepting deposits; and issuing electronic money (regulated activities). The FSA has published detailed regulatory requirements contained in a Handbook of Rules and Guidance.

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The FSA s statutory objectives are to maintain confidence in, and to promote public understanding of, the UK financial system; to secure an appropriate degree of consumer protection; and to reduce the scope for financial crime. In achieving these objectives, the FSA must take account of certain principles of good regulation which include recognising the responsibilities of authorised firms own management, facilitating innovation and competition and acting proportionately in imposing burdens on the industry.

1.2 *Authorised firms in the Group*

As at 31 December 2004, 35 companies in the Group, spanning a range of financial services sectors (banking, insurance and investment business), are authorised and regulated to conduct regulated activities by the FSA. These companies are referred to as authorised firms.

The FSA supervises the banking business of the UK based banks in the Group, including The Royal Bank of Scotland plc (The Royal Bank), National Westminster Bank Plc (NatWest), Coutts & Co, Ulster Bank Limited and Tesco Personal Finance Limited.

General insurance business is principally undertaken by RBS Insurance Group, whilst life assurance business is undertaken by Royal Scottish Assurance plc and National Westminster Life Assurance Limited (with the Group s partner, the AVIVA Group) and Direct Line Life Insurance Company Limited. Investment management business is principally undertaken by companies in the Wealth Management Division, including Adam & Co Investment Management Limited, and Coutts & Co Investment Management Limited, and in the Corporate Banking & Financial Markets Division, RBS Asset Management Ltd.

1.3 *The FSA s regulatory approach and supervisory standards*

The regulatory regime focuses on the risks to the FSA of not meeting its statutory objectives and uses the full range of regulatory tools (including the authorisation of firms, rule-making, supervision, investigation and enforcement) available to the FSA. It is founded on a risk based, integrated approach to regulation.

The FSA can request information from and give directions to, authorised firms. It may also require authorised firms to provide independent reports prepared by professionals. The FSA can exercise indirect control over the holding companies of authorised firms via its statutory powers to object to persons who are, or will become, controllers of these firms.

As part of its regulatory approach the FSA carries out regular risk assessments of the firms in the Group and they are subject generally to direct and on-going FSA supervision.

Setting standards for firms

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The FSA carries out the prudential supervision and conduct of business regulation of all authorised firms and also regulates the conduct of their business in the UK.

Currently, the application of its conduct of business rules to banking business and general insurance business is limited but the FSA assumed powers to regulate general insurance intermediation activities from January 2005 (as noted below).

Prudential supervision includes monitoring the adequacy of a firm's management, its financial resources and internal systems and controls. Firms are required to submit regular returns to the FSA which provide material for supervisory assessment. Different prudential requirements have applied to different sectors of the financial services industry. However, the FSA has prepared an Integrated Prudential Sourcebook (IPSB) aimed at applying a more harmonised and consistent approach to prudential regulation across the whole industry. From 1 January 2005, insurers were the first industry segment to comply with the FSA's new IPSB requirements. Implementation for the remainder of the industry is expected in stages, from 1 January 2005 until 1 January 2008.

The EU Financial Groups Directive came into force on 1 January 2005 and was implemented as part of the FSA's IPSB requirements. This will create an additional set of regulatory requirements recognising the insurance, investment and banking business of certain financial sector groups as financial conglomerates.

Many of the standards relating to the capital, which firms must hold to absorb losses arising from risks to its business, are determined by EU legislation or are negotiated internationally. The current capital adequacy regime requires firms to maintain certain levels of capital, of certain specified types (or tiers), against particular business risks.

A parallel process of reviewing and revising the current EU Capital Adequacy requirements is also underway. This will impact on all European banks and investment firms. The EU Capital Requirements Directive is currently being reviewed by the EU Parliament prior to National implementation by 1 January 2008. In the UK, the relevant changes will be implemented via changes to the FSA's IPSB.

In its supervisory role, the FSA sets requirements relating to matters such as consolidated supervision, capital adequacy, liquidity, large exposures, and the adequacy of accounting procedures and controls. Banks are required to set out their policy on large exposures and to inform the FSA of this. The policy must be reviewed annually and any significant departures from policies must be discussed with the FSA. Large exposures must be monitored and controlled.

Additional information continued

Supervision and regulation *(continued)*

As regards the insurance industry, the FSA's primary objective is to regulate and supervise the industry so that policyholders have confidence that they have bought appropriate products, that UK insurers are able to meet their liabilities and that they treat customers fairly. The FSA sets requirements relating to margins of solvency (i.e. the excess of the value of assets over the amount of liabilities). Companies carrying out insurance business are required to submit regular returns covering reserves and solvency to the FSA.

On 15 January 2005, the FSA commenced regulation of the sale and administration of general insurance and certain other types of insurance contracts.

Firms must also meet standards relating to senior management and internal systems and controls and must comply with rules designed to reduce the scope for firms to be used for money laundering. Revised Joint Money Laundering Steering Group Guidance Notes came into force in 2004. The EU published its draft Third Money Laundering Directive which aims to consolidate the two previous Anti Money Laundering Directives. Implementation is expected in 2006.

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Conduct of business standards essentially govern key aspects of firms' relationships with customers, and require the provision of clear and adequate information, the managing of conflicts of interest and the recommending of products suitable to the needs of customers. The marketing of financial products (particularly investment products) is subject to detailed requirements.

FSA rules relating to the provision of advice on packaged products (i.e. personal pensions, life assurance and collective investment schemes) were changed on 1 December 2004. The previous rules required businesses either to be independent or tied to only one product provider. The FSA has now abolished these rules. There is a six month transitional period for firms to amend their documentation and processes. Firms can continue to be independent or they can associate themselves in a variety of ways with many product providers. The changes are not expected to have any significant impact on RBSG.

1.4 Focus on customers

An important element in securing an appropriate degree of consumer protection is ensuring that suitable arrangements are made for dealing with customer complaints. Firms are required to establish appropriate internal complaint handling procedures and to report complaints statistics to the FSA. Where an issue cannot be resolved by the parties it may be referred for independent assessment to the Financial Ombudsman Service.

The FSA's high level principles require all regulated firms to treat their customers fairly. Since 2000 the FSA has undertaken a number of industry wide thematic reviews on this issue, and this activity will continue into 2005. The FSA have indicated that they will include assessment of firms' effectiveness in this area in the firms' ARROW assessments from 2005.

The Financial Services Compensation Scheme (financed by levies on authorised firms) is available to provide compensation up to certain limits if a firm collapses owing money to investors, depositors or policyholders.

1.5 Fraud

Towards the end of October 2004, the FSA launched its new policy on combating fraud in the financial services industry - Fighting Fraud in Partnership. The FSA is working on a programme of activities focusing on (i) actions that the FSA will take, (ii) FSA support for work by trade associations and the industry, (iii) creating closer relationships with law enforcement agencies and, (iv) the Government making fraud a higher law enforcement priority leading the development of a fraud strategy.

1.6 Enforcement

Where appropriate, the FSA may discipline and/or prosecute for breaches of the legislative or regulatory requirements. The FSA works closely with the criminal authorities and uses both civil and criminal powers. It can withdraw a firm's authorisation, discipline firms and individuals, prosecute for various offences and require funds to be returned to customers.

The FSA also has powers under certain consumer legislation to take action against authorised firms to address unfair terms in financial services consumer contracts.

1.7 Extension of the FSA's responsibilities

From 31 October 2004, the scope of the FSA's responsibilities was widened to cover the regulation and supervision of mortgage lending and administration and the provision of mortgage advice. Arrangements relating to the sale and administration of general insurance (and certain other insurance) contracts became regulated from 15 January 2005. These activities are undertaken by companies in the Group and this extension of the scope of statutory regulation is likely to have a significant impact on how the relevant businesses operate in the future.

1.8 Other relevant UK agencies and Government departments

Consumer credit issues are covered by the Department of Trade and Industry (DTI) and the Office of Fair Trading (OFT) and competition issues are dealt with by the OFT.

The business of granting consumer credit is heavily regulated. Aspects of the consumer credit business are under review, at both national and EU levels. Some changes to UK legislation were implemented from October 2004 (primarily changes to advertising requirements), with others coming into force in May 2005 and legislation to further amend the UK regime scheduled for 2005. An EU Consumer Credit Directive is also under negotiation.

1.9 *The European dimension*

An increasing amount of national financial services regulation, in the UK and in other Member States, emanates from the European Union. An extensive programme of legislation under the EU's Financial Services Action Plan is nearly complete, aiming to develop key aspects of the single European market in financial services across its (now) 25 countries. This Plan includes significant measures such as the endorsement of International Accounting Standards, revisions of EU Company Law, the updated Investment Services Directive and Directives on Market Abuse, Distance Marketing in Consumer Financial Services, and Takeovers. Some changes were implemented in 2004, others are still being implemented, with important proposals such as the legal framework for a single European payments area still in development. A debate was launched by the European Commission in 2004 around future EU action relating to financial services, beyond major existing projects such as the Capital Requirements Directive.

2 *United States*

As the ultimate parent of Citizens' subsidiary banks, the company is a bank holding company within the meaning of, and subject to regulation under, the US Bank Holding Company Act of 1956, as amended (the "BHCA"), by the Board of Governors of the Federal Reserve System (the "Board"). Under current Board policy, the company is expected to act as a source of financial strength to its US bank subsidiaries. The BHCA generally prohibits the company from acquiring, directly or indirectly, the ownership or control of more than 5% of the voting shares of any company engaged in non-banking activities in the United States unless the Board has determined, by order or regulation, that such activities are so closely related to banking or managing or controlling banks as to be a proper incident thereto. In addition, the BHCA requires the company to obtain the prior approval of the Board before acquiring, directly or indirectly, the ownership or control of more than 5% of the voting shares of any US bank or bank holding company. However, the US Gramm-Leach-Bliley Act of 1999 (the "GLBA") permits bank holding companies that have met certain eligibility criteria and elected to become 'financial holding companies' to engage in a significantly broader range of non-banking activities than those described above. Under the GLBA and related Board regulations, the company elected to become a financial holding company effective as of 9 February 2004.

The company's US bank and non-bank subsidiaries, and the Royal Bank and NatWest's US offices, are subject to direct supervision and regulation by various other federal and state authorities. Citizens' bank subsidiaries are subject to regulation by state banking authorities and the US Federal Deposit Insurance Corporation and the Royal Bank's New York branch is supervised by the New York Banking Department. NatWest's New York branch was closed at the end of April 2004. The company's US securities affiliates are subject to regulation and supervision by the Securities and Exchange Commission and Charter One, which was acquired by Citizens in August 2004 is regulated by the Office of the Comptroller of the Currency.

3 *Regulatory developments for capital and risk management*

The Basel Committee on Banking Supervision, which meets at the Bank of International Settlements in Switzerland, sets the standards for firms' weighted risk asset calculations and associated regulatory capital triggers. This Committee published a revised framework, called Basel 2, in June 2004. Full adoption of these new rules is expected by January 2008.

Application of Basel 2 differs between jurisdictions. In the EU, the Accord becomes law through the Capital Requirements Directive (CRD/CAD3) and associated changes to national laws or regulatory guidelines (for example the FSA's Integrated Prudential Sourcebook). Within the US, regulators have the flexibility to implement the Accord directly, after a Final Notice of Prudential Rulemaking. The EU is applying the Accord to all banks and investment firms. The US is taking a different approach, mandating that their largest internationally active banks use the Advanced approaches for credit and operational risk calculations; other banks can either remain on Basel 1 or opt-into Basel 2. Our US subsidiary, Citizens, currently falls outside the group of mandated Basel 2 banks for purposes of US regulation.

The Accord, based around three Pillars of Minimum Capital Requirements (Pillar 1), Supervisory Review (Pillar 2) and Market Discipline (Pillar 3), presents a fundamental change to the current capital adequacy regime and will have wide ranging consequences for the banking industry as a whole. The Group is actively involved in dialogue with various regulatory groups and is taking the necessary steps to prepare for the new Accord.

Additional information continued

Description of property and equipments

The Group operates from a number of locations worldwide, principally in the UK. At 31 December 2004, the Royal Bank and NatWest had 642 and 1,631 retail branches, respectively, in the UK. Citizens had 1,613 retail banking offices (including in-store branches) covering Connecticut, Delaware, Illinois, Indiana, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island and Vermont. A substantial majority of the UK branches are owned by the Royal Bank, NatWest and their subsidiaries or are held under leases with unexpired terms of over 50 years. The Group's principal properties include its headquarters at St Andrew Square, Edinburgh, its principal offices in London at 135 and 280 Bishopsgate and the Drummond House administration centre located at South Gyle, Edinburgh. A new corporate headquarters is being developed at Gogarburn, Edinburgh, which is due to open in 2005.

Freehold and long leasehold properties are revalued on a rolling basis, each property being valued at least once every five years. Interim valuations outwith the five year cycle are carried out on properties where there is an indication that its value has changed significantly, given market conditions. Any increase or deficit on revaluation is reflected in the carrying value of premises at that time. Any impairment in the value of premises where there is a clear consumption of economic benefits is charged in full to the profit and loss account. Other impairments of premises are charged to the profit and loss account after eliminating any previous revaluation surplus on the premises. Any profit from the sale of revalued premises is calculated by deducting the revalued amount from the net proceeds. The revaluation of premises at 31 December 2004 resulted in a £56 million increase in property revaluation reserves.

Total capital expenditure on premises, computers and other equipment for the year ended 31 December 2004 was £1,513 million (2003 £2,613 million; 2002 £872 million).

Major shareholders

Details of major shareholders in the company's ordinary and preference shares are given on page 63.

With the exception of Santander Central Hispano S.A. which sold (i) 86.7 million ordinary shares representing 2.9% of the company's ordinary share capital on 25 November 2002, (ii) 79 million ordinary shares representing 2.5% of the company's ordinary share capital on 9 September 2004 and (iii) 82 million shares representing 2.5% of the company's ordinary share capital on 27 January 2005 (and the remainder of SCH's shareholding in the company), there have been no significant changes in the percentage ownership of major shareholders of the company's ordinary and preference shares during the three years ended 23 February 2005. All shareholders within a class of the company's shares have the same voting rights. The company is not directly or indirectly owned or controlled by another corporation or any foreign government.

At 23 February 2005, the directors of the company had options to purchase a total of 1,800,211 ordinary shares of the company.

As at 31 December 2004, almost all of the company's US\$ denominated preference shares were held by shareholders registered in the US. All other shares were predominantly held by shareholders registered outside the US.

Material contracts

The company and its subsidiaries are party to various contracts in the ordinary course of business. For the year ended 31 December 2004, there have been no material contracts entered into outside the ordinary course of business.

Shareholder information

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Shareholder information

Financial calendar
Annual general meeting

20 April 2005 at 2.00 pm,
Edinburgh International Conference Centre,
The Exchange, Morrison Street, Edinburgh

Interim results

4 August 2005

Dividends

Payment dates:

| | |
|---|--|
| *Ordinary shares (2004 Final) | 3 June 2005 |
| Ordinary shares (2005 Interim) | October 2005 |
| Cumulative preference shares | 31 May and 30 December 2005 |
| Non-cumulative dollar preference shares | 31 March, 30 June, 30 September and 30 December 2005 |

Ex-dividend dates:

| | |
|------------------------------|--------------|
| Ordinary shares (2004 Final) | 9 March 2005 |
| Cumulative preference shares | 4 May 2005 |

Record dates:

| | |
|------------------------------|---------------|
| Ordinary shares (2004 Final) | 11 March 2005 |
| Cumulative preference shares | 6 May 2005 |

* If the necessary approvals are obtained from shareholders at the annual general meeting on 20 April 2005, as an alternative to cash, a scrip dividend election will be offered and shareholders will receive details of this by letter after that date.

Shareholder enquiries

Shareholdings in the company may be checked by visiting our website (www.rbs.com/shareholder). You will need the shareholder reference number printed on your share certificate or tax voucher to gain access to this information.

Braille and audio Annual Review and Summary Financial Statement

Shareholders requiring a Braille or audio version of the Annual Review and Summary Financial Statement should contact the Registrar on 0870 702 0135.

ShareGift

The company is aware that shareholders who hold a small number of shares may be retaining these shares because dealing costs make it uneconomical to dispose of them. ShareGift, the charity share donation scheme is a free service operated by The Orr Mackintosh Foundation (registered charity 1052686) to enable shareholders to donate unwanted shares to charity.

Should you wish to donate your shares to charity in this way you should contact ShareGift for further information:

ShareGift, The Orr Mackintosh Foundation,
46 Grosvenor Street, London W1K 3HN
Tel: 020 7337 0501
www.ShareGift.org

Donating your shares in this way will not give rise to either a gain or a loss for UK capital gains tax purposes and you may be able to reclaim UK income tax on gifted shares. Further information can be obtained from the UK Inland Revenue or your local tax office.

Capital gains tax

For shareholders who held RBS ordinary shares at 31 March 1982, the market value of one ordinary share held was 103p. After adjusting for the 1 March 1985 rights issue, the 1 September 1989 capitalisation issue and the bonus issue of Additional Value Shares on 12 July 2000, the adjusted 31 March 1982 base value of one ordinary share held currently is 46.1p.

For shareholders who held NatWest ordinary shares at 31 March 1982, the market value of one ordinary share held was 85.16p for shareholders who accepted the basic terms of the RBS offer. This takes account of the August 1984 and June 1986 rights issues and the June 1989 bonus issue of NatWest ordinary shares as well as the subsequent issue of Additional Value Shares.

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When disposing of shares, shareholders are also entitled to indexation allowance (to April 1998 only in the case of individuals and non-corporate holders), which is calculated on the 31 March 1982 value, on the cost of subsequent purchases from the date of purchase and on the subscription for rights from the date of that payment. Further adjustments must be made where a shareholder has chosen to receive shares instead of cash for dividends. Individuals and non-corporate shareholders may also be entitled to some taper relief to reduce the amount of any chargeable gain on disposal of shares.

The information set out above is intended as a general guide only and is based on current United Kingdom legislation and Inland Revenue practice as at this date. This information deals only with the position of individual shareholders who are resident in the United Kingdom for tax purposes, who are the beneficial owners of their shares and who hold their shares as an investment. It does not deal with the position of shareholders other than individual shareholders, shareholders who are resident outside the United Kingdom for tax purposes or certain types of shareholders, such as dealers in securities.

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Analyses of ordinary shareholders at 31 December 2004

| | shareholdings | millions | % of total |
|--------------------------------|---------------|----------|---------------|
| Individuals | 170,022 | 237.9 | 7.5 |
| Banks and nominee companies | 23,731 | 2,762.7 | 87.1 |
| Investment trusts | 145 | 0.8 | |
| Insurance companies | 339 | 11.6 | 0.4 |
| Other companies | 2,200 | 144.7 | 4.5 |
| Pension trusts | 37 | 9.6 | 0.3 |
| Other corporate bodies | 104 | 5.3 | 0.2 |
| | 196,578 | 3,172.6 | 100.0 |
| Range of shareholdings: | | | |
| 1 1,000 | 129,864 | 45.2 | 1.4 |
| 1,001 10,000 | 61,136 | 166.0 | 5.2 |
| 10,001 100,000 | 4,161 | 105.6 | 3.4 |
| 100,001 1,000,000 | 1,041 | 338.9 | 10.7 |
| 1,000,001 10,000,000 | 326 | 926.7 | 29.2 |
| 10,000,001 and over | 50 | 1,590.2 | 50.1 |
| | 196,578 | 3,172.6 | 100.0 |

Trading market

On 13 September 1995, 16 October 1996, 26 March 1997, 12 February 1998, 8 February 1999, 30 July 1999, 30 September 1999, 12 June 2001, 30 September 2004 and 26 August 2004 the company issued the following American Depositary Shares (ADSs) in the United States:

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7,000,000 Series D (Series D ADSs) representing 7,000,000 non-cumulative dollar preference shares, Series D;
 8,000,000 Series E (Series E ADSs) representing 8,000,000 non-cumulative dollar preference shares, Series E;
 8,000,000 Series F (Series F ADSs) representing 8,000,000 non-cumulative dollar preference shares, Series F;
 10,000,000 Series G (Series G ADSs) representing 10,000,000 non-cumulative dollar preference shares, Series G;
 12,000,000 Series H (Series H ADSs) representing 12,000,000 non-cumulative dollar preference shares, Series H;
 12,000,000 Series I (Series I ADSs) representing 12,000,000 non-cumulative dollar preference shares, Series I;
 9,000,000 Series J (Series J ADSs) representing 9,000,000 non-cumulative dollar preference shares, Series J;
 16,000,000 Series K (Series K ADSs) representing 16,000,000 non-cumulative dollar preference shares, Series K;
 34,000,000 Series L (Series L ADSs) representing 34,000,000 non-cumulative dollar preference shares Series L; and
 37,000,000 Series M (Series M ADSs) representing 37,000,000 non-cumulative dollar preference shares Series M.

Each of the respective ADSs represents the right to receive one corresponding preference share, is evidenced by an American Depositary Receipt (ADR) and is listed on the New York Stock Exchange (NYSE).

The ADRs evidencing the ADSs above were issued pursuant to Deposit Agreements, among the company, The Bank of New York as depository, and all holders from time to time of ADRs issued thereunder. Currently, there is no non-United States trading market for any of the non-cumulative dollar preference shares. All of the non-cumulative dollar preference shares are held by the depository, as custodian, in bearer form.

At 31 December 2004, there were 238 registered shareholders of Series D ADSs, 129 registered shareholders of Series E ADSs, 144 registered shareholders of Series F ADSs, 90 registered shareholders of Series G ADSs, 90 registered shareholders of Series H ADSs, 109 registered shareholders of Series I ADSs, 73 registered shareholders of Series J ADSs, 64 registered shareholders of Series K ADSs, 9 registered shareholders of Series L ADSs and 1 registered shareholder of Series M ADSs.

On 29 March 1994 and 23 June 2003, respectively, the company issued 8,000,000 Exchangeable Capital Securities (X-CAPs), Series A and 34,000,000 Exchangeable Capital Securities, Series B, each in connection with a public offering in the United States. On 30 September 2004, all of the outstanding Series B X-CAPs were exchanged into 34,000,000 non-cumulative dollar preference shares, Series L. The Series A X-CAPs are listed on the NYSE and trade under the symbol RBSPRX . Currently, there is no non-US market for the Series A X-CAPs.

On 20 August 2001, the company issued US\$1.2 billion of perpetual regulatory tier one securities (PROs) in connection with a public offering in the United States.

The ADSs, the X-CAPs and the PROs are listed on the NYSE.

Shareholder information continued

The following table shows the high and low sales prices for each of the outstanding ADSs, X-CAPs and PROs for the periods indicated, as reported on the NYSE composite tape:

| Figures in US\$ | | Series D ADSs | Series E ADSs | Series F ADSs | Series G ADSs | Series H ADSs | Series I ADSs | Series J ADSs | Series K ADSs | Series L ADSs | Series M ADSs | Series A X-CAPs | Series PROs ⁽¹⁾ |
|-----------------|------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|--------------------|----------------------------|
| By month | | | | | | | | | | | | | |
| February 2005 | High | 26.45 | 27.50 | 27.96 | 25.97 | 25.76 | 25.95 | 26.59 | 26.84 | 24.90 | 26.75 | 26.95 | 127.98 |
| | Low | 26.05 | 27.00 | 27.50 | 25.60 | 25.55 | 25.70 | 26.13 | 26.60 | 24.59 | 26.07 | 26.05 | 123.07 |
| January 2005 | High | 26.48 | 27.40 | 28.00 | 25.81 | 25.70 | 25.79 | 26.25 | 26.84 | 24.64 | 26.39 | 26.93 | 127.98 |
| | Low | 26.26 | 26.96 | 27.33 | 25.55 | 25.45 | 25.57 | 25.49 | 26.37 | 24.30 | 26.06 | 26.09 | 123.07 |

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| | | | | | | | | | | | | | |
|----------------|------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|--------|
| December 2004 | High | 26.68 | 27.89 | 27.90 | 25.92 | 25.87 | 26.00 | 26.08 | 27.18 | 24.68 | 26.16 | 26.66 | 122.52 |
| | Low | 25.89 | 27.00 | 27.16 | 25.39 | 25.30 | 25.49 | 25.64 | 26.32 | 24.15 | 25.76 | 26.15 | 117.44 |
| November 2004 | High | 26.96 | 28.30 | 27.78 | 25.67 | 25.58 | 25.88 | 26.07 | 27.12 | 24.45 | 26.05 | 26.37 | 121.24 |
| | Low | 26.50 | 27.67 | 27.25 | 25.41 | 25.41 | 25.45 | 25.81 | 26.78 | 23.89 | 25.45 | 26.03 | 118.07 |
| October 2004 | High | 26.66 | 28.35 | 27.82 | 25.50 | 25.44 | 25.55 | 25.88 | 27.04 | 24.10 | 25.64 | 26.16 | 122.09 |
| | Low | 26.39 | 27.56 | 27.42 | 25.30 | 25.31 | 25.30 | 25.54 | 26.75 | 23.51 | 25.21 | 25.72 | 118.48 |
| September 2004 | High | 27.45 | 28.38 | 28.15 | 25.75 | 25.62 | 25.79 | 26.40 | 27.30 | | 25.35 | 26.34 | 121.77 |
| | Low | 26.42 | 27.56 | 27.45 | 25.29 | 25.19 | 25.29 | 25.53 | 26.52 | | 25.15 | 25.70 | 117.13 |

By quarter

| | | | | | | | | | | | | | |
|----------------------|------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|--------|
| 2004: Fourth quarter | High | 26.96 | 28.35 | 27.90 | 25.92 | 25.87 | 26.00 | 26.08 | 27.18 | 24.68 | 26.16 | 26.66 | 122.52 |
| | Low | 25.89 | 27.00 | 27.16 | 25.30 | 25.30 | 25.30 | 25.54 | 26.32 | 23.51 | 25.21 | 25.72 | 117.44 |
| 2004: Third quarter | High | 27.45 | 28.38 | 28.15 | 25.75 | 25.62 | 25.79 | 26.40 | 27.30 | | 25.35 | 26.34 | 121.77 |
| | Low | 26.08 | 26.65 | 26.65 | 25.12 | 24.95 | 25.20 | 25.53 | 26.30 | | 25.13 | 25.30 | 112.21 |
| 2004: Second quarter | High | 27.22 | 29.00 | 28.10 | 25.65 | 25.41 | 26.00 | 26.41 | 27.97 | | | 26.02 | 122.11 |
| | Low | 25.84 | 25.90 | 25.65 | 24.20 | 24.45 | 25.14 | 25.42 | 25.70 | | | 25.25 | 110.58 |
| 2004: First quarter | High | 27.90 | 29.00 | 28.45 | 25.90 | 25.67 | 26.25 | 27.05 | 28.00 | | | 26.61 | 125.14 |
| | Low | 26.96 | 27.99 | 27.65 | 25.30 | 25.15 | 25.70 | 26.17 | 27.21 | | | 25.74 | 116.87 |
| 2003: Fourth quarter | High | 27.75 | 29.16 | 28.50 | 25.80 | 25.85 | 26.50 | 27.43 | 27.90 | | | 27.15 | 120.21 |
| | Low | 26.86 | 27.92 | 27.67 | 25.25 | 25.10 | 25.77 | 26.35 | 26.87 | | | 26.06 | 112.70 |
| 2003: Third quarter | High | 28.30 | 29.15 | 28.97 | 25.85 | 26.04 | 27.12 | 27.19 | 27.84 | | | 27.00 | 123.89 |
| | Low | 27.24 | 27.30 | 27.20 | 25.23 | 25.28 | 25.65 | 26.30 | 26.05 | | | 26.00 | 111.06 |
| 2003: Second quarter | High | 29.00 | 29.20 | 29.05 | 25.96 | 26.35 | 27.19 | 27.89 | 28.20 | | | 27.25 | 130.78 |
| | Low | 27.25 | 27.70 | 27.41 | 25.16 | 25.51 | 26.20 | 26.94 | 27.15 | | | 26.50 | 113.27 |
| 2003: First quarter | High | 28.90 | 29.00 | 28.12 | 26.00 | 26.40 | 27.40 | 28.00 | 27.79 | | | 27.15 | 119.11 |
| | Low | 26.76 | 27.01 | 27.03 | 25.00 | 25.35 | 26.11 | 26.59 | 26.85 | | | 26.45 | 113.79 |

By year

| | | | | | | | | | | | | | |
|----------|------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|--------|
| 2004 (2) | High | 27.90 | 29.00 | 28.45 | 25.92 | 25.87 | 26.25 | 27.05 | 28.00 | 24.68 | 26.16 | 26.66 | 125.14 |
| | Low | 25.84 | 25.90 | 25.65 | 24.20 | 24.45 | 25.14 | 25.42 | 25.70 | 23.51 | 25.13 | 25.25 | 110.58 |
| 2003 (2) | High | 29.00 | 29.20 | 29.05 | 26.00 | 26.40 | 27.40 | 28.00 | 28.20 | | | 27.25 | 130.78 |
| | Low | 26.76 | 27.01 | 27.03 | 25.00 | 25.10 | 25.65 | 26.30 | 26.05 | | | 26.00 | 111.06 |
| 2002 (2) | High | 27.77 | 28.20 | 28.00 | 25.73 | 26.05 | 27.08 | 27.50 | 27.30 | | | 27.00 | 116.36 |
| | Low | 25.74 | 25.53 | 25.15 | 24.46 | 24.27 | 24.50 | 25.45 | 24.79 | | | 25.35 | 100.07 |
| 2001 (2) | High | 27.99 | 27.94 | 27.20 | 25.86 | 27.15 | 27.00 | 28.85 | 26.95 | | | 27.20 | 106.44 |
| | Low | 25.38 | 25.25 | 24.31 | 22.94 | 22.75 | 24.63 | 24.80 | 22.17 | | | 25.50 | 96.58 |
| 2000 (3) | High | 25.50 | 25.31 | 24.63 | 23.00 | 22.94 | 25.00 | 25.50 | | | | 26.00 | |
| | Low | 20.63 | 19.81 | 19.13 | 18.88 | 17.63 | 19.63 | 21.13 | | | | 21.56 | |

Notes:

- (1) Price quoted as a % of US\$1,000 nominal.
- (2) Year ended 31 December.
- (3) 15 months ended 31 December.

Memorandum and articles of association

The following information is a summary of certain terms of the company's Memorandum of Association (the "Memorandum") and Articles of Association (the "Articles") as in effect at the date of this Annual Report and certain relevant provisions of the Companies Act 1985, as amended (the "Act") as relevant to the holders of any class of share. The Articles were last amended on April 29, 2004. The following summary description is qualified in its entirety by reference to the terms and provisions of the Memorandum and Articles. The Memorandum and Articles are registered with the Registrar of Companies of Scotland. Holders of any class of share are encouraged to read the full Memorandum and Articles, which have been filed with the SEC.

Incorporation and registration

The company was incorporated and registered in Scotland under the Companies Act 1948 as a limited company on 25 March 1968 under the name National and Commercial Banking Group Limited. On 10 March 1982, it changed its name to its present name and was registered under the Companies Acts 1948 to 1980 as a public company with limited liability. The company is registered under Company No. SC 45551.

Purpose and objects

The Memorandum provides, amongst other things, that its objects are to carry on the business of banking in all or any of its aspects and to carry on the business of a holding company. The company's objects are set out in full in clause 4 of the Memorandum.

Directors

At each annual general meeting of the company, one third of the directors (or the number nearest to one third) subject to retirement will retire by rotation and be eligible for re-election. The directors to retire will be those who have been longest in office since their last appointment or re-election or, in the case of those who were appointed or re-elected on the same day, will (unless they otherwise agree) be determined by lot. Each director must retire by rotation at the third annual general meeting following the general meeting at which he was appointed or last re-elected. In addition, if there is only one director who is subject to retirement by rotation, he must retire.

Directors may be appointed by the company by ordinary resolution or by the Board. A director appointed by the Board holds office only until the next annual general meeting, whereupon he will be eligible for re-election, and is not taken into account in determining the directors who are to retire by rotation at that meeting. Unless and until otherwise determined by ordinary resolution, the directors (other than alternate directors) shall be not more than twenty five. There is no stipulation in the Articles regarding a minimum number of directors; under the Act, and in the absence of express provision, the minimum number is two.

Directors' interests

A director shall not vote at a meeting of the Board or a committee of the Board on any resolution of the Board concerning a matter in which he has an interest (otherwise than by virtue of his interest in shares, debentures or other securities of, or otherwise in or through, the company) which (together with any interest of any person connected with him) is, to his knowledge, material unless his interests arises only because the resolution relates to one or more of the following matters:

- i. the giving of any security or indemnity to him pursuant to the Articles or in respect of money lent, or obligations incurred, by him at the request of, or for the benefit of, the company or any of its subsidiary undertakings;
- ii. the giving of any security or indemnity to a third party in respect of a debt or obligation of the company or any of its subsidiary undertakings for which he has assumed responsibility (in whole or in part) under a guarantee or indemnity or by the giving of security;

- iii. a proposal concerning an offer of shares, debentures or other securities of the company, or any of its subsidiary undertakings, for subscription or purchase, in which offer he is, or may be, entitled to participate as a holder of securities or in the underwriting or sub-underwriting of which he is to participate;
- iv. a contract, arrangement, transaction or proposal concerning any other body corporate in which he is interested, directly or indirectly, whether as an officer or shareholder or otherwise, provided that he is not the holder of shares representing one per cent or more of any class of the equity share capital of such body corporate;
- v. any proposal concerning the adoption, modification or operation of a pension fund or retirement, death or disability benefits scheme or employees' share scheme which relates both to directors and employees of the company or a subsidiary of the company and does not provide any privilege in respect of any director which it does not accord to the employees to which the fund or scheme relates;
- vi. a contract or arrangement for the benefit of the employees of the company or any of its subsidiary undertakings which does not award him any privilege or benefit not generally accorded to the employees to whom the contract or arrangement relates; and
- vii. a proposal concerning any insurance which the company proposes to purchase and/or maintain for, or for the benefit of, any directors or for persons who include directors of the company.

Borrowing powers

The directors may exercise all the powers of the company to borrow money and to mortgage or charge its undertaking, property and uncalled capital and to issue debentures and other securities, whether outright or as collateral security for any debt, guarantee, liability or obligation of the company, or of any third party.

Retirement

In accordance with section 293 of the Act and the Articles, no person who has attained the age of 70 may be appointed to the Board and any serving director reaching that age must vacate his office at the conclusion of the annual general meeting commencing next after he or she attains the age of 70.

Notwithstanding the foregoing, directors of any age may be appointed to or remain on the Board if that appointment is or was made or approved by the company in a general meeting provided that special notice containing the age of the relevant director is given.

Qualifying shareholding

Directors are not required to hold any shares of the company by way of qualification.

Classes of shares

The company has issued and outstanding the following 3 general classes of shares, namely ordinary shares, preference shares and non-voting deferred shares to which the provisions set forth below apply. In addition, the company has authorized as part of its share capital Additional Value Shares (AVSs). All of the issued AVSs were converted into non-voting deferred shares in December 2003. The terms of those AVSs are set out in Schedule 4 to the Articles.

Dividends

General

Subject to the provisions of the Act and clause 133 of the Articles, the company may, by ordinary resolution, declare dividends on ordinary shares save that no dividend shall be payable except out of profits available for

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distribution, or in excess of the amount recommended by the Board or in contravention of the special rights attaching to any share.

Any dividend which has remained unclaimed for 12 years from the date of declaration shall be forfeited and shall revert to the company. The company may cease sending dividend warrants and cheques by post or otherwise to a member if such instruments have been returned undelivered to, or left uncashed by, that member on at least two consecutive occasions, or, following one such occasion, reasonable enquiries have failed to establish any new address or account of the registered holder. The company may resume sending warrants and cheques if the holder requests such recommencement in writing.

Preference shares

Each cumulative preference share confers the right to a fixed cumulative preferential dividend payable half-yearly. Each non-cumulative preference share confers the right to a preferential dividend (not exceeding a specified amount) payable in the currency of the relevant share. The rate of such dividend and the date of payment thereof, together with the terms and conditions of the dividend, are as may be determined by the directors prior to allotment. Cumulative preference share dividends are paid in priority to any dividend on any other class of share.

The non-cumulative preference shares rank for dividend after the cumulative preference shares but rank *pari passu* with each other and any shares expressed to rank, in terms of participation in the profits of the company, in some or all respects *pari passu* therewith and otherwise in priority to dividends payable on the ordinary shares and any other share capital in the company.

The directors may resolve prior to the issue and allotment of any series of non-cumulative preference shares that full dividends in respect of a particular dividend payment date will not be declared and paid if, (i) in its sole and absolute discretion, the directors resolve prior to the relevant dividend payment date that such dividend (or part thereof) shall not be paid and/or (ii) in the opinion of the directors, payment of a dividend would cause a breach of the UK Financial Services Authority's capital adequacy requirements applicable to the company or its subsidiaries, or subject to the next following paragraph, insufficient distributable profits of the company are available to cover the payment in full of all dividends after having paid any dividends payable on any of the cumulative preference shares.

If dividends will be paid but, in the opinion of the directors, insufficient distributable profits of the company are available to cover the payment in full of dividends after having paid any dividends payable on any of the cumulative preference shares, dividends will be declared by the directors, *pro rata* on the non-cumulative preference shares to the extent of the available distributable profits.

The non-cumulative preference shares will carry no further rights to participate in the profits of the company and if, and to the extent, any dividend or part of any dividend is on any occasion not paid for any of the reasons described above, holders of non-cumulative preference shares will have no claim in respect of such non-payment.

If any dividend is not payable for the reasons described in clause (ii) of this subsection, the directors may pay a special dividend not exceeding US\$0.01, £0.01 or 0.01 (depending on the currency of the relevant preference share) per share.

If the dividend payable on any series of non-cumulative preference shares on the most recent payment date is not paid in full, or if a sum is not set aside to provide for such payment in full, in either case for the reasons set forth in

clause (ii) of this subsection, no dividends may be declared on any other share capital of the company and no sum may be set aside for the payment of a dividend on any other share capital (in each case other than the cumulative preference shares), unless, on the date of declaration, an amount equal to the dividend payable in respect of the then current dividend period for such series of non-cumulative preference shares is set aside for payment in full on the next dividend payment date.

If any dividend payable on the non-cumulative preference shares is not paid in full or if a sum is not set aside to provide for such payment in full (in either case for the reasons set forth in clause (ii) of this subsection), the company may not redeem or purchase or otherwise acquire any other share capital of the company and may not set

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aside any sum nor establish any sinking fund for its redemption, purchase or other such acquisition, until such time as dividends have been declared and paid in full in respect of successive dividend periods together aggregating not less than twelve months.

The non-payment of any dividend (in full or in part) by reason of the exercise of the directors' discretion referred to in clause (i) of this subsection, shall not prevent or restrict (a) the declaration and payment of dividends on any other series of non-cumulative preference shares or on any non-cumulative preference shares expressed to rank pari passu with the non-cumulative preference shares, (b) the setting aside of sums for the payment of such dividends, (c) except as set forth in the following paragraph, the redemption, purchase or other acquisition of shares in the company by the company, or (d) except as set forth in the following paragraph, the setting aside of sums, or the establishment of sinking funds, for any such redemption, purchase or other acquisition by the company.

If dividends are not declared and paid in full on any series of non-cumulative preference shares as a result of the directors' discretion referred to in clause (i) of this subsection, then the company may not redeem, purchase or otherwise acquire for any consideration any share capital ranking after such preference shares, and may not set aside any sum nor establish any sinking fund for the redemption, purchase or other acquisition thereof, until such time as the company has declared and paid in full dividends on such series of non-cumulative preference shares in respect of successive dividend periods together aggregating no less than twelve months. In addition, no dividend may be declared or paid on any of the company's share capital ranking after such preference shares until the dividend in respect of a particular dividend payment date payable on the preference shares to which the directors' discretion in clause (i) of this subsection applies has been declared and paid in full.

Non-voting deferred shares

The holders of non-voting deferred shares are not entitled to the payment of any dividend or other distribution.

Distribution of assets on liquidation

Cumulative preference shares

In the event of a return of capital on a winding-up or otherwise, the holders of cumulative preference shares are entitled to receive out of the surplus assets of the company available for distribution amongst the members (i) in priority to the holders of the non-cumulative preference shares and any other shares ranking pari passu therewith, the arrears of any fixed dividends including the amount of any dividend due for a payment after the date of commencement of any winding-up or liquidation but which is payable in respect of a half-year period ending on or before such date and (ii) pari passu with the holders of the non-cumulative preference shares and any other shares ranking pari passu therewith, the amount paid up or credited as paid up on such shares together with any premium.

Non-cumulative preference shares

Each non-cumulative preference share will confer on a winding up or liquidation (except (unless otherwise provided by the terms of issue) a redemption or purchase by the company of any shares in the capital of the company), the right to receive out of surplus assets of the company available for distribution amongst the members after payment of the arrears (if any) of the cumulative dividend on the cumulative preference shares and in priority to the holders of the ordinary shares, repayment of the amount paid up or credited as paid up on the non-cumulative preference shares together with any premium paid on issue pari passu with the holders of the cumulative preference shares and together with an amount equal to accrued and unpaid dividends.

Non-voting deferred shares

On a winding-up or other return of capital of the company, holders of non-voting deferred shares are entitled only to payment of the amounts paid up on the non-voting deferred shares, after repayment to the holders of ordinary shares of the nominal amount paid up on the ordinary shares held by them and payment of £100,000 on each ordinary share.

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General

On a winding-up of the company, the liquidator may, with the authority of any extraordinary resolution and any other sanction required by the Insolvency Act 1986 and subject to the rights attaching to any class of shares after payment of all liabilities, including the payment to holders of preference shares, divide amongst the members in specie or kind the whole or any part of the assets of the company or vest the whole or any part of the assets in trustees upon such trusts for the benefit of the members and may determine the scope and terms of those trusts. No member shall be compelled to accept any assets on which there is a liability.

Voting Rights

General

Subject to any rights or restrictions as to voting attaching to any shares or class of shares, on a show of hands every member who is present in person at a general meeting shall have one vote and on a poll every member present in person or by proxy shall have one vote for each 25 pence in nominal amount of shares held by him. No member shall, unless the directors otherwise determine, be entitled to vote at a general meeting or at a separate meeting of the holders of shares in the capital of the company, either in person or by proxy, in respect of any share held by him unless all monies presently payable by him in respect of that share have been paid.

The quorum required for a meeting of members is not less than five members present in person and entitled to vote. If a meeting is adjourned because of the lack of a quorum, the members present in person or by proxy and entitled to vote will constitute a quorum at the adjourned meeting.

Meetings are convened upon written notice of not less than 21 days in respect of meetings of members called for the passing of a special resolution or annual general meetings of members, and not less than 14 days in respect of most other meetings of members.

Cumulative preference shares

At a general meeting of the company, every holder of a cumulative preference share who is present in person shall be entitled to one vote on a show of hands and, on a poll, every person who is present in person or by proxy shall have one vote for each 25 pence in nominal amount of shares held. No member shall be entitled to vote any share

in person or by proxy unless all moneys owed in respect of that share have been paid.

Non-cumulative preference shares

Holders of non-cumulative preference shares are not entitled to attend or vote at any general meeting unless the business of the meeting includes the consideration of a resolution for the winding-up of the company or any resolution directly varying or abrogating the rights attached to any such shares and then in such case only to speak to and vote upon any such resolution.

However, holders have the right to vote in respect of any matter when the dividend payable on their shares has not been declared in full for such number of dividend periods as the directors shall determine prior to the allotment thereof.

Whenever a holder is entitled to vote at a general meeting, on a show of hands every shareholder who is present in person has one vote and, on a poll, every such holder who is present in person or by proxy shall have such number of votes as may be determined by the directors prior to allotment.

Non-voting deferred shares

The holders of non-voting deferred shares are not entitled to receive notice of or to attend or vote at any general meeting of the company or otherwise receive any shareholder communication.

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Redemption

Unless the directors determine, prior to allotment of any particular series of non-cumulative preference shares, that such series shall be non-redeemable, the preference shares will be redeemable at the option of the company on any date (a "Redemption Date") which (subject to certain exceptions described in the terms of such shares) falls no earlier than such date (if any) as may be fixed by the directors, prior to allotment of such shares. On redemption, there shall be paid on each non-cumulative preference share the aggregate of its nominal amount together with any premium paid on issue, where applicable a redemption premium and accruals of dividend.

Purchase

General

Subject to the Act, the company may, by special resolution, reduce its share capital, any capital redemption reserve and any share premium account or other undistributable reserve and may also, subject to the Act, the requirements of the London Stock Exchange and the rights attached to any class of shares, purchase its own shares (including redeemable shares).

Non-cumulative preference shares and convertible preference shares

Subject to the Act, the company may purchase any non-cumulative preference shares and convertible preference shares upon such terms as the directors shall determine provided that, where the shares being purchased are listed on the London Stock Exchange, the purchase price payable, exclusive of expenses and accrued dividends, shall not exceed (a) in the case of a purchase in the open market, or by tender, the average of the closing middle market quotations of such shares for the 10 dealing days preceding the date of the purchase of (if higher), in the case of a purchase in the open market only, the market price on the date of purchase provided that such market price is not more than 105 per cent of such average and (b) in the case of a purchase by private treaty, 120 per

cent of the closing middle market quotation of such shares for the last dealing day preceding the date of purchase; but so that this proviso shall not apply to any purchase of such shares made in the ordinary course of a business of dealing in securities. Upon the purchase of any such shares, the nominal amount of such shares shall thereafter be divided into, and reclassified as, ordinary shares.

Conversion rights

Convertible preference shares carry the right to convert into ordinary shares if they have not been the subject of a notice of redemption from the company, on or before a specified date determined by the directors. The right to convert will be exercisable by service of a conversion notice on the company within a specified period. The company will use reasonable endeavours to arrange the sale, on behalf of convertible preference shareholders who have submitted a conversion notice, of the ordinary shares which result from such conversion and to pay to them the proceeds of such sale so that they receive net proceeds equal to the nominal value of the convertible preference shares which were the subject of the conversion notice and any premium at which such shares were issued, provided that ordinary shares will not be sold at below a benchmark price (as determined prior to the issue of the relevant convertible preference shares by the directors).

In December 2003, following the payment of aggregate dividends of £1 in respect of each AVS, all issued and outstanding AVSs were de-listed from the Official List and from trading on the London Stock Exchange's market for listed securities and converted into non-voting deferred shares of £0.01 each.

Changes in share capital and variation of rights

Subject to the provisions of the Act and without prejudice to any rights attached to any existing shares or class of shares, any share may be issued with such rights or restrictions as the company may by ordinary resolution determine or, subject to and in default of such determination, as the Board shall determine. Subject to the provisions of the Act, the company may issue shares which are, or at the option of the company or the holder are liable, to be redeemed. Subject to the provisions of the Act and the Articles, unissued shares are at the disposal of the Board.

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The company may by ordinary resolution: increase its share capital; consolidate and divide all or any of its share capital into shares of larger amount than its existing shares; subject to the provisions of the Act, subdivide its shares, or any of them, into shares of smaller amount than is fixed by the Memorandum; or cancel any shares which have not been taken or agreed to be taken by any person and diminish the amount of its share capital by the amount of the shares so cancelled.

Subject to the provisions of the Act, if at any time the capital of the company is divided into different classes of shares, the rights attached to any class of shares may (unless further conditions are provided by the terms of issue of the shares of that class) be varied or abrogated, whether or not the company is being wound up, either with the consent in writing of the holders of three-quarters in-nominal value of the issued shares of the class or with the sanction of an extraordinary resolution passed at a separate general meeting of holders of the shares of the class (but not otherwise).

To any such separate general meeting the provision of the Articles relating to general meetings will apply, save that:

- (i) if at any adjourned meeting of such holders a quorum as defined above is not present, two people who hold shares of the class, or their proxies, are a quorum; and
- (ii) any such holder present in person or by proxy may demand a poll.

The rights attaching to any class of shares having preferential rights are not, unless otherwise expressly provided by the terms of issue thereof, deemed to be varied by the creation or issue of further shares ranking, as regards participation in the profits or assets of the company, *pari passu* therewith, but in no respect in priority thereto.

Disclosure of interests in shares

The Act gives the company the power to require persons who it believes to be, or have been within the previous three years, interested in its shares, to disclose prescribed particulars of those interests. Failure to supply the information or supplying a statement which is materially false may lead to the Board imposing restrictions upon the relevant shares. The restrictions available are the suspension of voting or other rights conferred by membership in relation to meetings of the company in respect of the relevant shares and, additionally, in the case of a shareholding representing at least 0.25 per cent of the class of shares concerned, the withholding of payment of dividends on, and the restriction of transfers of, the relevant shares.

Limitations on rights to own share

There are no limitations imposed by UK law or the Memorandum and Articles on the right of non-residents or foreign persons to hold or vote the company's shares other than the limitations that would generally apply to all of the company's shareholders.

Members resident abroad

Members with registered addresses outside the United Kingdom are not entitled to receive notices from the company unless they have given the company an address within the United Kingdom at which such notices may be served.

Taxation for US Holders

The following discussion summarises certain US federal and UK tax consequences of the acquisition, ownership and disposition of non-cumulative dollar preference shares, ADSs, X-CAPs or PROs by a beneficial owner that is a citizen or resident of the United States or that otherwise will be subject to US federal income tax on a net income basis in respect of the non-cumulative dollar preference shares, ADSs, X-CAPs or PROs (a *US Holder*). This summary assumes that a US Holder is holding non-cumulative dollar preference shares, ADSs, X-CAPs or PROs, as applicable, as capital assets. This summary does not address the tax consequences to a US Holder (i) that is resident (or, in the case of an individual, ordinarily resident) in the UK for UK tax purposes or (ii) generally, that is a corporation which alone or together with one or more associated companies, controls, directly or indirectly, 10% or more of the voting stock of the company.

The statements and practices set forth below regarding US and UK tax laws, including the US/UK double taxation convention relating to income and capital gains which entered into force on 31 March 2003 (the *New Treaty*), the prior US/UK double tax convention relating to income and capital gains (the *Prior Treaty*) and the US/UK double taxation convention relating to estate and gift taxes (the *Estate Tax Treaty*), are based on those laws and practices as in force and as applied in practice on the date of this Report. This summary is not exhaustive of all possible tax considerations and holders are advised to satisfy themselves as to the overall tax consequences, including specifically the consequences under US federal, state, local and other laws, and possible changes in taxation law, of the acquisition, ownership and disposition of non-cumulative dollar preference shares, ADSs, X-CAPs or PROs by consulting their own tax advisers.

References below to *the Treaty* are references to either the *Prior Treaty* or the *New Treaty* as applicable.

For the purposes of the *Treaty*, the *Estate Tax Treaty* and the US Internal Revenue Code of 1986, as amended (the *Code*), US Holders of ADSs will be treated as owners of the non-cumulative dollar preference shares underlying such ADSs.

Preference shares or ADSs Taxation of dividends

The company is not required to withhold tax at source from dividend payments it makes or from any amount (including any amounts in respect of accrued dividends) distributed by the company.

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Before 1 May 2004, if a US Holder would have been entitled to greater benefits under the Prior Treaty, that US Holder could have elected to continue to apply the Prior Treaty to dividend payments made before that date.

New Treaty

Because payments of dividends by the company to non-UK investors are not subject to UK withholding tax, it is not necessary to apply the New Treaty in order to receive a reduced rate of withholding. Since there is no UK withholding tax on payments of dividends to US Holders, US Holders will not be entitled to a foreign tax credit for foreign taxes paid as a result of the payment of dividends by the company.

Prior Treaty effect of UK tax credit

An individual shareholder who is resident in the UK for UK tax purposes and who receives a dividend from the company is entitled to claim a tax credit in the UK against its income tax liability attributable to the dividend.

Although a US Holder that receives a dividend from the company will not be entitled to this UK tax credit, certain US Holders are entitled to a tax credit payment (the Tax Credit Amount). However, a US holder would not actually receive this Tax Credit Amount because of UK withholding tax.

Dividends paid by the company and any Tax Credit Amount will constitute foreign source dividend income for US federal income tax purposes to the extent paid out of the current or accumulated earnings and profits of the company, as determined for US federal income tax purposes. Payments will not be eligible for the dividends-received deduction allowed to corporate US Holders.

Subject to applicable limitations that may vary depending upon a holder's individual circumstances, dividends paid to certain non-corporate US Holders in taxable years beginning before 1 January 2009 will be taxable at a maximum tax rate of 15%. Non-corporate US Holders should consult their own tax advisers to determine whether they are subject to any special rules that limit their ability to be taxed at this favourable rate.

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Shareholder information continued

Taxation for US Holders *(continued)*

Taxation of capital gains

A US Holder that is not resident (or, in the case of an individual, ordinarily resident) in the UK will not normally be liable for UK tax on capital gains realised on the disposition of such holder's non-cumulative dollar preference share or ADS unless at the time of the disposal, in the case of a corporate US Holder, such US Holder carries on a trade in the UK through a permanent establishment or, in the case of any other US Holder, such US Holder carries on a trade, profession or vocation in the UK through a UK branch or agency and such non-cumulative dollar preference share or ADS is or has been used, held or acquired by or for the purposes of such trade (or profession or vocation), permanent establishment, branch or agency. Special rules apply to individuals who are temporarily not resident or ordinarily resident in the UK.

A US Holder will, upon the sale, exchange or redemption of a non-cumulative dollar preference share or ADS generally recognise capital gain or loss for US federal income tax purposes (assuming in the case of a redemption, that such US Holder does not own, and is not deemed to own, any ordinary shares of the company) in an amount equal to the difference between the amount realised (excluding in the case of a redemption any amount treated as a dividend for US federal income tax purposes, which will be taxed accordingly) and the US Holder's tax basis in the non-cumulative dollar preference share or ADS.

A US Holder who is liable for both UK and US tax on gain recognised on the disposal of a non-cumulative dollar preference share or ADS will generally be entitled, subject to certain limitations, to credit the UK tax against its US federal income tax liability in respect of such gain.

Estate and gift tax

A non-cumulative dollar preference share or ADS held by an individual, whose domicile is determined to be the United States for purposes of the Estate Tax Treaty and who is not a national of the UK, will not be subject to UK inheritance tax on the individual's death or on a lifetime transfer of the non-cumulative dollar preference share or ADS, except in certain cases where the non-cumulative dollar preference share or ADS (i) is comprised in a settlement (unless, at the time of the settlement, the settlor was domiciled in the United States and was not a national of the UK); (ii) is part of the business property of a UK permanent establishment of an enterprise; or (iii) pertains to a UK fixed base of an individual used for the performance of independent personal services. The Estate Tax Treaty generally provides a credit against US federal estate or gift tax liability for the amount of any tax paid in the UK in a case where the non-cumulative dollar preference share or ADS is subject to both UK inheritance tax and US federal estate or gift tax.

UK stamp duty and stamp duty reserve tax (SDRT)

The following is a summary of the UK stamp duty and SDRT consequences of transferring an ADS in registered form (otherwise than to the custodian on cancellation of the ADS) or of transferring a non-cumulative dollar preference share. A transfer of a registered ADS executed and retained in the United States will not give rise to stamp duty and an agreement to transfer a registered ADS will not give rise to SDRT.

Stamp duty or SDRT will normally be payable on or in respect of transfers of non-cumulative dollar preference shares and accordingly any holder who acquires or intends to acquire non-cumulative dollar preference shares is advised to consult its own tax advisers in relation to stamp duty and SDRT.

X-CAPs

United States

Because the X-CAPs have no stated maturity, can be exchanged for preference shares or ADSs at the option of the company, would be treated as if they were preference shares in a winding-up of the company, and the company may elect not to make payments on the X-CAPs, the X-CAPs will be treated as equity for US federal income tax purposes.

Payments (including any UK withholding tax, as to which see below) will constitute foreign source dividend income for US federal income tax purposes to the extent paid out of the current or accumulated earnings and profits of the company, as determined for US federal income tax purposes. Payments will not be eligible for the dividends-received deduction allowed to corporate US Holders.

Subject to applicable limitations that may vary depending upon a holder's individual circumstances, dividends paid to certain non-corporate US Holders in taxable years beginning before 1 January 2009 will be taxable at a maximum tax rate of 15%. Non-corporate US Holders should consult their own tax advisers to determine whether they are subject to any special rules that limit their ability to be taxed at this favourable rate.

A US Holder will, upon the sale, exchange or redemption of X-CAPs, generally recognise capital gain or loss for US federal income tax purposes (assuming in the case of a redemption, that such US Holder does not own, and is not deemed to own, any ordinary shares of the company). A US Holder who is liable for both UK and US tax on gain recognised on the disposal of the X-CAPs will generally be entitled, subject to certain limitations, to credit the UK tax against its US federal income tax liability in respect of such gain.

Gain or loss will not be recognised by a US Holder upon the exchange of X-CAPs for preference shares or ADSs pursuant to the company's exercise of its exchange right. A US Holder's basis in the preference shares or ADSs received in exchange for its X-CAPs will be the same as the US Holder's basis in the X-CAPs at the time of the exchange and the US Holder's holding period for the preference shares or ADSs received in the exchange will include the holding period of the X-CAPs exchanged.

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United Kingdom

Taxation of payments of interest

Payments on the X-CAPs will constitute interest rather than dividends for UK withholding tax purposes. However, the X-CAPs will constitute quoted eurobonds within the meaning of section 349 of the Income and Corporation Taxes Act 1988, and therefore payments of interest will not be subject to withholding or deduction for or on account of UK taxation as long as X-CAPs remain at all times listed on the New York Stock Exchange or some other recognised stock exchange within the meaning of section 841 of the Income and Corporation Taxes Act 1988. In all other cases an amount must be withheld on account of UK income tax at the lower rate (currently 20%) subject to any direction to the contrary by the Inland Revenue under the Treaty and except that the withholding obligation is disapplied in respect of payments to persons who the company reasonably believes are within the charge to corporation tax or fall within various categories enjoying a special tax status (including charities and pension funds), or are partnerships consisting of such persons (unless the Inland Revenue directs otherwise).

If interest were paid under deduction of UK income tax (e.g., if the X-CAPs lost their listing), US Holders may be able to claim a refund of the tax deducted under the Treaty.

Any paying agent or other person through whom interest is paid to, or by whom interest is received on behalf of, an individual, may be required to provide information in relation to the payment and the individual concerned to the UK Inland Revenue. The Inland Revenue may communicate this information to the tax authorities of other jurisdictions.

The UK Inland Revenue confirmed at around the time of issue of the X-CAPs that interest payments should not be treated as distributions for UK tax purposes by reason of (i) the fact that interest may be deferred under the terms of issue or (ii) the undated nature of the X-CAPs, provided that at the time an interest payment is made, the X-CAPs are not held by a company which is associated with the company or by a funded company. A company will be associated with the company if, broadly speaking, it is in the same group as the company. A company will be a funded company for these purposes if there are arrangements involving that company being put in funds (directly or indirectly) by the company, or an entity associated with the company. In this respect, the Inland Revenue has confirmed that a company holding an interest in X-CAPs which incidentally has banking facilities with any company associated with the company will not be a funded company by virtue of such facilities.

Interest on the X-CAPs constitutes UK source income for UK tax purposes and, as such, may be subject to income tax by direct assessment even where paid without withholding.

However, interest with a UK source received without deduction or withholding on account of UK tax will not be chargeable to UK tax in the hands of a US Holder unless, in the case of a corporate US Holder, such US Holder carries on a trade in the UK through a UK permanent establishment or in the case of other US Holders, such persons carry on a trade, profession or vocation in the UK through a UK branch or agency in connection with which the interest is received or to which the X-CAPs are attributable. There are exemptions for interest received by certain categories of agents (such as some brokers and investment managers).

EU Directive on taxation of savings income

The European Union has adopted a new directive regarding the taxation of savings income. Subject to a number of important conditions being met, Member States of the European Union will be required from a date not earlier than 1 July 2005 to provide to the tax authorities of other Member States details of payments of interest or other similar income paid by a person to an individual in another Member State, except that Belgium, Luxembourg and Austria will instead impose a withholding system for a transitional period unless during such period they elect otherwise.

Disposal (including redemption)

A disposal (including redemption) of X-CAPs by a non-corporate US Holder, will not give rise to any liability to UK taxation on capital gains unless the US Holder carries on a trade (which for this purpose includes a profession or vocation) in the UK through a branch or agency and the X-CAPs are, or have been, held or acquired for the purposes of that trade, branch or agency. The exchange by such US Holder of X-CAPs for preference shares or ADSs pursuant to the company's exercise of its exchange right will not give rise to a charge to UK tax on capital gains even if such US Holder would be subject to tax on a disposal of such holder's X-CAPs in accordance with the tax treatment referred to previously.

A transfer of X-CAPs by a US Holder will not give rise to a charge to UK tax on accrued but unpaid interest payments, unless the US Holder is an individual or other non-corporate tax payer and at any time in the relevant year of assessment or accounting period carries on a trade in the UK through a branch or agency to which the X-CAPs are attributable.

Annual tax charges

Corporate US Holders of X-CAPs may be subject to annual UK tax charges (or relief) by reference to fluctuations in exchange rates and in respect of profits, gains and losses arising from the X-CAPs, but only if such corporate US Holders carry on a trade, profession or vocation in the UK through a UK permanent establishment to which the X-CAPs are attributable.

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Shareholder information continued

Taxation for US Holders *(continued)*

Inheritance tax

X-CAPs in bearer form physically held outside the UK should not be subject to UK inheritance tax in respect of a lifetime transfer by, or the death of, a US Holder who is neither domiciled nor deemed to be domiciled in the UK for inheritance tax purposes. However, in relation to X-CAPs held through DTC (or any other clearing system), the position is not free from doubt and the Inland Revenue are known to consider that the situs of securities held in this manner is not necessarily determined by the place in which the securities are physically held. If X-CAPs in bearer form are or become situated in the UK, or if X-CAPs are held in registered form, there may be a charge to UK inheritance tax as a result of a lifetime transfer at less than fair market value by, or on the death of, such US Holder. However, exemption from, or a reduction of, any such UK tax liability may be available under the Estate Tax Treaty in the same manner as for non-cumulative dollar preference shares. US Holders should consult their professional advisers in relation to such potential liability.

Stamp duty and SDRT

No UK stamp duty is payable on the transfer by delivery or redemption of bearer X-CAPs, whether in definitive form or in the form of one or more global X-CAPs. No SDRT is payable on any agreement to transfer bearer X-CAPs provided that the agreement is not made in contemplation of, or as part of an arrangement for, a takeover of the company.

No UK stamp duty will be payable in respect of any instrument of transfer of depositary interests representing X-CAPs, provided that any instrument relating to such transfer is not executed in the UK, and remains at all times outside the UK. Depositary interests representing X-CAPs will not be chargeable securities for SDRT purposes, and consequently a transfer of such depositary interests will not be subject to SDRT. Although the position is not clear, the transfer on the sale of X-CAPs in registered form may attract ad valorem UK stamp duty or (if an unconditional agreement to transfer X-CAPs is not completed by a duly stamped transfer) UK SDRT, generally at the rate of 0.5% of the consideration paid, which, in the case of stamp duty, will be rounded up to £5 or multiples thereof. The transfer of X-CAPs in registered form to, or to a nominee or agent for, a person whose business (i) is or includes issuing depositary receipts or (ii) is or includes the provision of clearance services, may give rise to a liability to UK stamp duty or (to the extent that UK stamp duty is not paid on an instrument of transfer) UK SDRT, generally at the rate of 1.5% of the price of the X-CAPs transferred, which, in the case of stamp duty, will be rounded up to £5 or multiples thereof. Such transfer of X-CAPs in bearer form may give rise to a charge to UK SDRT generally at the rate of 1.5% of the price of the X-CAPs transferred. A charge to UK SDRT may also arise on the issue of X-CAPs whether in registered or bearer form to, or to a nominee or agent for, a person whose business is or includes issuing depositary receipts or includes the provision of clearance services, generally at the rate of 1.5% of the price of the X-CAPs issued.

PROs

United States

Payments of interest on a PRO (including any UK tax withheld therefrom) will constitute foreign source dividend income for US federal income tax purposes to the extent paid out of the current or accumulated earnings and profits of the company, as determined for US federal income tax purposes. Payments will not be eligible for the dividends-received deduction allowed to corporate US Holders. A US Holder who is entitled under the Treaty to a refund of UK tax, if any, withheld on a payment will not be

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entitled to claim a foreign tax credit with respect to such tax. See *United Kingdom Taxation of Payments on the PROs* below for a discussion of circumstances in which UK withholding may apply.

Subject to applicable limitations that may vary depending upon a holder's individual circumstances, dividends paid to certain non-corporate US Holders in taxable years beginning before 1 January 2009 will be taxable at a maximum tax rate of 15%. Non-corporate US Holders should consult their own tax advisers to determine whether they are subject to any special rules that limit their ability to be taxed at this favourable rate.

A US Holder will, upon the sale, exchange or redemption of a PRO, generally recognise capital gain or loss for US federal income tax purposes in an amount equal to the difference between the amount realised (excluding any amount in respect of mandatory interest and any Missed Payments which are to be satisfied on a Missed Payment Satisfaction Date, which would be treated as ordinary income) and the US Holder's tax basis in the PRO (assuming, in the case of a redemption, that such US Holder does not own, and is not deemed to own, any ordinary shares of the company). A US Holder who is liable for both UK and US tax on a gain recognised on the disposal of PROs will generally be entitled, subject to certain limitations, to credit the UK tax against its US federal income tax liability in respect of such gain.

United Kingdom Taxation of payments on the PROs

Payments on the PROs will constitute interest rather than dividends for UK withholding tax purposes. However, the PROs will constitute quoted eurobonds within the meaning of section 349 of the Income and Corporation Taxes Act 1988 and therefore payments of interest will not be subject to withholding or deduction for or on account of UK taxation as long as the PROs remain at all times listed on a recognised stock exchange within the meaning of section 841 of the Income and Corporation Taxes Act 1988. In all other cases, an amount must be withheld on account of UK income tax at the lower rate (currently 20%) subject to any direction to the contrary by the Inland Revenue under the Treaty and except that the withholding obligation is disapplied in respect of payments to persons who the company reasonably believes are within the charge to corporation tax or fall within various categories enjoying a special tax status (including charities and pension funds), or are partnerships consisting of such persons (unless the Inland Revenue directs otherwise). Where interest

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has been paid under deduction of UK withholding tax, US Holders may be able to recover the tax deducted under the Treaty. If interest were paid under deduction of UK income tax (e.g., if the PROs lost their listing), US Holders may be able to claim a refund of the tax deducted under the Treaty.

Any paying agent or other person by or through whom interest is paid to, or by whom interest is received on behalf of, an individual, may be required to provide information in relation to the payment and the individual concerned to the UK Inland Revenue. The Inland Revenue may communicate this information to the tax authorities of other jurisdictions.

The UK Inland Revenue confirmed at around the time of the issue of the PROs that interest payments would not be treated as distributions for UK tax purposes by reason of (i) the fact that interest may be deferred under the terms of issue or (ii) the undated nature of the PROs, provided that at the time an interest payment is made, the PROs are not held by a company which is associated with the company or by a funded company. A company will be associated with the company if, broadly speaking, it is part of the same group as the company. A company will be a funded company for these purposes if there are arrangements involving that company being put in funds (directly or indirectly) by the company, or an entity associated with the company. In this respect, the Inland Revenue has confirmed that a company holding an interest in the PROs which incidentally has banking facilities with any company associated with the company will not be a funded company by virtue of such facilities.

Interest on the PROs constitutes UK source income for UK tax purposes and, as such, may be subject to income tax by direct assessment even where paid without withholding. However, interest with a UK source received without deduction or withholding on account of UK tax will not be chargeable to UK tax in the hands of a US Holder unless, in the case of a corporate US Holder, such US Holder carries on a trade in the UK through a UK permanent establishment or in the case of other US Holders, such persons carry on a trade, profession or vocation in the UK through a UK branch or agency in connection with which the interest is received

or to which the PROs are attributable. There are exemptions for interest received by certain categories of agent (such as some brokers and investment managers).

EU Directive on taxation of savings income

The European Union has adopted a new directive regarding the taxation of savings income. Subject to a number of important conditions being met, Member States of the European Union will be required from a date not earlier than 1 July 2005 to provide to the tax authorities of other Member States details of payments of interest and other similar income paid by a person to an individual resident in another Member State, except that Belgium, Luxembourg and Austria will instead impose a withholding system for a transitional period unless during such period they elect otherwise.

Disposal (including redemption)

A disposal (including redemption) of PROs by a non-corporate US Holder, will not give rise to any liability to UK taxation on capital gains unless the US Holder carries on a trade (which for this purpose includes a profession or a vocation) in the UK through a branch or agency and the PROs are, or have been, held or acquired for the purposes of that trade, branch or agency.

A transfer of PROs by a US Holder will not give rise to a charge to UK tax on accrued but unpaid interest payments, unless the US Holder is an individual or other non-corporate tax payer and at any time in the relevant year of assessment or accounting period carries on a trade in the UK through a branch or agency to which the PROs are attributable.

Annual tax charges

Corporate US Holders of PROs may be subject to annual UK tax charges (or relief) by reference to fluctuations in exchange rates and in respect of profits, gains and losses arising from the PROs, but only if such corporate US Holders carry on a trade, profession or vocation in the UK through a UK permanent establishment to which the PROs are attributable.

Inheritance tax

In relation to PROs held through DTC (or any other clearing system), the UK inheritance tax position is not free from doubt in respect of a lifetime transfer, or death of, a US Holder who is not domiciled nor deemed to be domiciled in the UK for inheritance tax purposes; the UK Inland Revenue are known to consider that the situs of securities held in this manner is not necessarily determined by the place where the securities are registered. In appropriate circumstances, there may be a charge to UK inheritance tax as a result of a lifetime transfer at less than fair market value by, or on the death of, such US Holder. However, exemption from, or a reduction of, any such UK tax liability may be available under the Estate Tax Treaty. US Holders should consult their professional advisers in relation to such potential liability.

Stamp duty and SDRT

No stamp duty, SDRT or similar tax is imposed in the UK on the issue, transfer or redemption of the PROs.

Shareholder information continued

Exchange controls

The company has been advised that there are currently no UK laws, decrees or regulations which would prevent the remittance of dividends or other payments to non-UK resident holders of the company's non-cumulative dollar preference shares.

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There are no restrictions under the articles of association of the company or under UK law, as currently in effect, which limit the right of non-UK resident owners to hold or, when entitled to vote, freely to vote the company's non-cumulative dollar preference shares.

Documents on display

Documents concerning the company may be inspected at 36 St Andrew Square, Edinburgh, EH2 2YB (telephone 0131 556 8555).

In addition, we file reports and other information with the SEC. You can read and copy these reports and other information at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. You can call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room or at the offices of The New York Stock Exchange, on which certain of our securities are listed, at 20 Broad Street, New York, New York 10005. The SEC also maintains a website at www.sec.gov which contains in electronic form each of the reports and other information that we have filed electronically with the SEC.

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Important addresses

Shareholder enquiries

Registrar

Computershare Investor Services PLC
PO Box 82
The Pavilions
Bridgwater Road
Bristol BS99 7NH
Telephone: 0870 702 0135
Facsimile: 0870 703 6009

Group Secretariat

The Royal Bank of Scotland Group plc
42 St Andrew Square
Edinburgh EH2 2YE
Telephone: 0131 523 0944
Facsimile: 0131 557 6140

Registered office

36 St Andrew Square
Edinburgh EH2 2YB
Telephone: 0131 556 8555

Registered in Scotland No. 45551

Website

www.rbs.com

Principal offices

The company

42 St Andrew Square Edinburgh EH2 2YE

The Royal Bank of Scotland plc

42 St Andrew Square Edinburgh EH2 2YE

280 Bishopsgate London EC2M 4RB

National Westminster Bank Plc

135 Bishopsgate London EC2M 3UR

Citizens

Citizens Financial Group, Inc.

One Citizens Plaza Providence Rhode Island 02903 USA

Ulster Bank

11-16 Donegall Square East Belfast BT1 5UB

George s Quay Dublin 2

RBS Insurance

Direct Line House 3 Edridge Road Croydon Surrey CR9 1AG

Churchill Court West Moreland Road Bromley BR1 1DP

RBS Greenwich Capital

600 Steamboat Road

Greenwich Connecticut 06830 USA

Coutts Group

440 Strand London WC2R 0QS

The Royal Bank of Scotland International Limited

Royal Bank House 71 Bath Street

St Helier Jersey Channel Islands JE4 8PJ

NatWest Offshore

23/25 Broad Street

St Helier Jersey Channel Islands JE4 8QG

The registered office of the company is 36 St Andrew Square
Edinburgh EH2 2YB (telephone 0131 556 8555).

The principal place of business of the company is
42 St Andrew Square, Edinburgh EH2 2YE
(telephone 0131 556 8555).

SEC Form 20-F cross reference guide

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- 15.1 Independent auditors' consent

* Previously filed and incorporated by reference to Exhibit 4.3 to Post-effective Amendment No. 2 to the Registration Statement on Form F-3 (Registration No. 333-100661).

** Previously filed and incorporated by reference to Exhibits 4.5 and 4.3, respectively, to the Group's Annual Report on Form 20-F for the fiscal year ended 31 December 2000 (File No. 1-10306).

*** Previously filed and incorporated by reference to Exhibits 4.2, 4.6 and 4.3.1, respectively, to the Group's Annual Report on Form 20-F for the fiscal year ended 31 December 2003 (File No. 1-10306).

**** Previously filed and incorporated by reference to Exhibit 4.5.1 to the Group's Annual Report on Form 20-F for the fiscal year ended 31 December 2002 (File No. 1-10306).

Signature

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

The Royal Bank of Scotland Group plc
Registrant

/s/ Fred Watt

Frederick Inglis Watt
Group Finance Director

29 March 2005