Company Registered Number: 2304

# THE ROYAL BANK OF SCOTLAND INTERNATIONAL LIMITED

## REPORT OF THE DIRECTORS AND FINANCIAL STATEMENTS

31 December 2019

# Contents


| | Page |
|---|---|
| Board of directors and secretary | 1 |
| Report of the directors | 2 |
| Statement of directors' responsibilities | 6 |
| Independent auditor's report to the members of the Royal Bank of Scotland International Limited | 7 |
| Income statement for the year ended 31 December 2019 | 9 |
| Statement of comprehensive income for the year ended 31 December 2019 | 10 |
| Balance sheet as at 31 December 2019 | 11 |
| Statement of changes in equity for the year ended 31 December 2019 | 12 |
| Cash flow statement for the year ended 31 December 2019 | 13 |
| Accounting policies | 14 |
| Notes to the accounts | 20 |

# Board of directors and secretary

**Chairman**
John Philip Ward Brewster

**Executive directors**
Andrew Martin McLaughlin
Chief Executive Officer

Lynn Ann Cleary
Chief Financial Officer

**Non-executive directors**
Louis Philip Chetwynd Taylor

Joanna Elizabeth Dentskevich (resigned 31 July 2019)

Stuart Porteous

Bruce Mark Cannon (appointed 9 January 2020)

Gregory John Branch (appointed 9 January 2020)

**Company Secretary**
Rachael Emma Pocklington

**Auditor**
Ernst & Young LLP
Castle Street
St Helier
Jersey
JE1 1EY

**Registered office and Head office**
Royal Bank House
71 Bath Street
St Helier
Jersey
JE4 8PJ

**The Royal Bank of Scotland International Limited**
Registered in Jersey, Channel Islands No. 2304

The directors of The Royal Bank of Scotland International Limited (the "Company"/"RBS International"/"RBSI"/the "Bank") present their annual report, together with the audited financial statements of the Company for the year ended 31 December 2019. The financial statements are prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IASB) and interpretations issued by the International Financial Reporting Interpretations Committee of the IASB.

## ACTIVITIES AND BUSINESS REVIEW

### Principal activities

The Bank is one of the largest banks operating in the Channel Islands, Isle of Man and Gibraltar with wholesale branches in Luxembourg and the UK. It provides a comprehensive range of financial services through its Local Banking and Institutional Banking customer segments. Local Banking provides loan and deposit products and services to personal, private, business and commercial customers. Institutional Banking provides services to European fund asset Managers, fund administrators and corporate service providers.

The directors do not anticipate any material change in the type or activities of the Company.

The Bank is a wholly-owned subsidiary of The Royal Bank of Scotland International (Holdings) Limited ('RBSIH'). The ultimate holding company is The Royal Bank of Scotland Group plc ('RBSG' or the 'ultimate holding company'), which provides support and access to all central resources.

The Bank will leverage this relationship to RBSG and other subsidiaries to continue to improve on the quality and efficiency of the services and products provided. Copies of the annual report of RBS can be obtained from Corporate Governance and Regulatory Affairs, RBS Gogarburn, Edinburgh EH12 1HQ, the Registrar of Companies or through the RBS website, www.rbs.com.

### Business review

The Bank's ambition is to become the number one bank for customer service, trust and advocacy in its chosen markets. The Company's customer advocacy has increased throughout 2019, showing the continued focus on service and sales behaviours. The Bank has started to work with technology partners to serve customers future needs. To help colleagues respond to rapid change, the bank has launched a multi-stage training program, covering future work-force capabilities and innovation.

We have made it much quicker to open personal savings accounts and request credit. For sole applicants, automated account opening has enabled the savings account journey for the majority of existing customers to reduce from 14 days to 8 minutes. Over 3,000 new accounts have been opened in 2019, saving circa 1,200 hours of manual processing. There have been 26 updates across the Bank's personal digital channels; driven by customer feedback, supporting a 17% increase in mobile adoption. Increased investment in the multi-currency banking platform, eQ, has improved the digital experience for institutional clients. These include a feedback tool, a live statement view and the ability to re-batch payments. All users have moved to the new version of eQ, making sure everyone has the same great functionality and experience.

The Company continues to develop its climate commitments in line with the RBSG strategic response, supporting renewable energy funds, which invest in a wide array of renewable energy assets including onshore and offshore wind, solar, biomass and other renewable technologies. Additionally, in 2019, the Company completed its first investor backed leverage facility supporting investment into large scale battery storage projects.

The Company's financial performance is presented in the Income Statement on page 9.

| Performance key metrics and ratios | 2019 | 2018 |
|---|---|---|
| Total income | £563m | £470m |
| Operating profit before tax | £335m | £272m |
| Loans and advances to customers | £14.1bn | £12.6bn |
| Customer deposits | £30.0bn | £26.0bn |
| Loan to Deposit ratio | 47% | 49% |
| Risk Weighted Assets (RWAs) | £6.6bn | £7.4bn |
| Core Equity Tier 1 (CET1) | £1.3bn | £1.7bn |
| CET1 capital ratio | 19.2% | 23.6% |
| Tier 1 Equity (T1) | £1.6bn | £1.7bn |
| T1 capital ratio | 23.7% | 23.6% |
| Leverage ratio(1) | 4.3% | 5.0% |
| Liquidity portfolio | £15.7bn | £14.2bn |
| Liquidity Coverage Ratio (LCR) | 137% | 127% |
| Assets held in a fiduciary capacity | £2.8bn | £3.0bn |

Notes:
(1) Leverage exposure is Tier 1 capital as a percentage of on and off balance sheet exposures in line with Jersey Financial Services Commission (JFSC) guidance.

#### Income
Income increased by 20% to £563m driven by increased levels of customer activity on both sides of the balance sheet. All the assets and liabilities of formerly Isle of Man Bank Limited ("IOMB") (currently known as Tilba Limited) were transferred to the Company in May 2019. Furthermore, the growth in the liquid investment portfolio which started toward the end of 2018 contributed an increase in the net interest income.

#### Operating expenses
Operating expenses increased by 13.5% to £226m. 2018 includes a conduct provision release of £8m. 2019 includes higher discretionary investment in our key customer journeys.

### Loans and advances to customers

Loans and advances to customers grew by £1.5bn during the year to £14.1bn. This includes loans transferred to the Company from Isle of Man Bank of £0.6bn. It also includes £0.6bn wholesale loans migrated from NatWest Markets Plc in December 2019. Underlying growth came from both Institutional and Local Banking franchises.

### Customer deposits

Customer deposits represent the Company's primary funding source. Year end balances comprised £9.7bn Local Banking deposits and £20.4bn Institutional Banking deposits. It includes deposits transferred to the Company from Isle of Man Bank of £1.6bn

### Capital Management

The Company's capital position remained strong during 2019, as evidenced by the CET1 ratio of 19.2% at 31 December 2019 (2018: 23.6%).

The movement in CET1 capital from £1.7bn to £1.3bn primarily reflects dividend payments of £762m (2018: £470m).

RWAs decreased by 9% in the year and reflect the reduction in intergroup positions.

During the year, the Company issued £300m Additional Tier 1 notes Capital (AT1) into its structure issued to RBS Group. These are obligations which rank senior to shareholders equity (Core Tier 1 capital in regulatory terms) in the creditor hierarchy, but more junior than all other forms of liability. The Bank continues to consider additional forms of capital to support its activities.

### Liquidity Management

The Company's liquidity position remained strong during 2019, evidenced by the Liquidity Coverage Ratio of 137% at 31 December 2019 (2018 - 127%). To support diversification of funding and liquidity metrics going forward, the Company established a Euro Commercial Paper programme toward the end of 2019.

The Company has repositioned its excess USD, GBP and Euro liquidity from placements with RBS Group entities into Central & Correspondent Banks. Structural hedges were moved into Sovereign Bond holdings.

All securities held are liquid assets which has active and liquid market. These securities are made of Gilts, Bonds & US Treasuries.

### Credit ratings

The Company's Credit Ratings at 31 December 2019 were:

| | |
|---|---|
| S&P | A- / A-2 (Stable) |
| Moody's | Baa1 / P-2 (Positive) |
| Fitch | A / F1 (Neutral) |

Notable developments during the year included:

- In July, Moody's assigned the Bank with a rating for the first time, with Positive Outlook.
- In May, S&P increased the Company's long-term rating by one notch, with Stable Outlook.

## ACCOUNTING POLICIES

The reported results of the Company are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. Details of the Company's accounting policies and key sources of estimation uncertainty are included within the Accounting policies on pages 14 to 19.

## RISK MANAGEMENT

The prevailing market and economic conditions pose risks for the Company. These include the level of defaults from customers on outstanding advances as well as the degree of uncertainty in the valuation of other financial assets and liabilities.

The financial position of the Company, its cash flows, liquidity position, capital and funding sources are set out in the financial statements. Notes 9 and 17 to the financial statements include the Company's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities and its exposures to credit and liquidity risks.Over the past year the Company's corporate governance and risk management frameworks have been strengthened. These enhancements complement the risk culture programme which seeks to make risk management a natural part of how colleagues think, behave and work.

## THE BOARD

The Board considers strategic issues and ensures the Company manages risk effectively through approving and monitoring the Company's risk appetite, considering stress scenarios and agreed mitigants and identifying longer term strategic threats to the Company's business operations. The Board's terms of reference includes key aspects of the Company's affairs reserved for the Board's decision and are reviewed at least annually.

There are a number of areas where the Board has delegated specific authority to management, including the Chief Executive Officer and Chief Financial Officer. These include responsibility for the operational management of the Company's businesses as well as reviewing high level strategic issues and considering risk appetite, risk policies and risk management strategies in advance of these being considered by the Board and/or its Committees.

The roles of Chairman and Chief Executive Officer are distinct and separate, with a clear division of responsibilities. The Chairman leads the Board and ensures the effective engagement and contribution of all executive, non-executive and independent non-executive directors. The Chief Executive Officer has responsibility for all Company businesses and acts in accordance with authority delegated by the Board. The independent non-executive directors combine broad business and commercial experience with independent and objective judgement and they provide independent challenge to the executive directors and leadership team.

In order to provide effective oversight and leadership the Board has established two Board Committees with particular responsibilities:

The Audit Committee assists the Board in discharging its responsibilities for monitoring the quality of the financial statements of the Company. It reviews the accounting policies, financial reporting and regulatory compliance of the Company and its systems and standards of internal controls, and monitors the work of internal and external audit.

The Board Risk Committee provides oversight and advice on current and potential future risk exposures of the Company and future risk strategy. It reviews compliance with risk appetite and oversees the operation of the policy framework and submission to regulators.

The Board has delegated day to day management of the business to the CEO. The CEO is supported by various management level committees including the Executive Committee which assists the CEO in managing strategic, financial, capital and operational issues related to the running of the business.

## DIRECTORS AND SECRETARY

The present directors and secretary, who have served during the year, are listed on page 1.

## COLLEAGUES

### Colleague engagement

The Bank values the input of its colleagues and actively seeks opportunities to engage with them to contribute to on-going dialogue and activities to make the Bank a better bank for our customers and colleagues. The survey of colleague opinions, known as 'Our View', provides valuable data to decision makers across the Bank in support of improving employee engagement and satisfaction. This progress is tracked through two surveys during the financial year, utilising questions common across the financial services industry to compare ourselves against our peers.80% of colleagues completed the staff opinion survey. Scores improved in all 15 categories and 13 are now above the Global Financial Services norm.

The Bank promotes flexible working for all colleagues. We help to facilitate flexible working and colleagues are able to avail of a range of flexible working options including regular or occasional working from home, working variable hours or working part time.

Through volunteering and fundraising the Company raised £61,279 for charity. For the 11th year running, the Bank was proud sponsor of the NatWest International Island Games. The 2019 games, held in Gibraltar, supported 1,700 athletes from 22 participating islands and the Bank's commitment to sponsor the Games continues in Guernsey 2021.

### Diversity and inclusion

The Bank has a Diversity and Inclusion Policy and values and promotes diversity in all areas of recruitment and employment. Building a working environment where all our colleagues can develop to their full potential is important to us irrespective of their age, belief, disability, ethnic or national origin, gender, gender identity, marital or civil partnership status, political opinion, race, religion or sexual orientation.

We work to avoid limiting potential through bias, prejudice or discrimination. The Bank recognises the beneficial contribution of a diverse mix of uniquely talented individuals for the delivery of great service to our diverse customer base. Key principles of our Diversity and Inclusion Policy include that we attract, motivate and retain the best talent. We base the employment relationship on the principles of fairness, respect and inclusion. We comply with local laws on equality and Our Code, which sets out the Bank's expected behaviours and standards of conduct, to build and develop an inclusive workforce in order to understand and respond to our diverse customer base.

### Developing our colleagues

Ongoing professional development for our colleagues is important to the Bank.

The Bank offers a wide range of learning opportunities including technical knowledge and skills. We need to prepare colleagues for the future and we continue to focus broader development on our Critical People Capabilities.

We're committed to developing colleagues in the five key critical capability areas we have identified, that will help build the right knowledge, skills and behaviours, to help our colleagues stay relevant and employable, and support our ambition and purpose. In addition, we are encouraging agility and shifting mindsets so that a focus on the future, continuous learning, knowledge sharing and reflective practice becomes the norm.

Sales Excellence is our complete bankwide sales programme. It teaches the tools and techniques that enable those in sales roles to be the best at ethical, needs-based selling.

### Rewarding our colleagues

Our approach to performance management provides clarity for our colleagues about how their contribution links to our ambition. It recognises contributions that support our values and holds individuals to account for behaviour and performance that does not.

## OUTLOOK

The Bank remains vulnerable to changes, risks and uncertainty in the external economic and political environment which, despite the strength of domestic economic conditions at present, remain heightened. Scenarios identified as having a potentially material negative impact on the Bank include: hard/disorderly forms of Brexit; persistent or more intense weakness in global economic growth; shifts in the international tax policy environment; persistently low or lower interest rates; global financial market volatility linked to the effects of highly accommodative monetary policy settings in advanced economies; vulnerabilities in emerging market economies resulting in contagion in the local market; potential legislative changes; and political and geopolitical instability.

The directors, noting the continued and forecast economic growth and cognisant of the macroeconomic and political risks, consider that the Bank's continued focus on strength and sustainability, customer experience, simplifying the Bank, supporting growth and colleague engagement will assist in the delivery of the Bank's vision to be number one bank for customer service, trust and advocacy.

### Economic and political landscape

The Bank continues to deal with a range of significant risks and uncertainties in the external economic, political and regulatory environment.
Scenarios identified as having a potentially negative impact on the Bank include

- Brexit related uncertainty which could result in subdued confidence in the near term.
- Further decreases in interest rates and/or continued sustained low or negative interest rates could put pressure on the Bank's interest margins and adversely affect the Bank's profitability. In addition, a continued period of low interest rates and flat yield curves has affected and may continue to affect the Bank's interest rate margin.
- Changes in currency rates, particularly in the sterling-US dollar and euro-sterling rates, can adversely affect the value of assets, liabilities, income, RWAs and expenses.
- Shifts in the international tax policy environment and imposition of levies and taxes can affect the distributable profits of the Bank, as the Bank is subject to tax laws and practice in the number of jurisdictions in which it has operations.
- Political and geopolitical instability could results in subdued confidence and impact on credit ratings.

## GOING CONCERN

The directors are satisfied with the financial position of the Company and believe that they are appropriately placed to manage their business risks successfully.

The financial position of the Company, its cash flows, liquidity position and borrowing facilities are set out in the financial statements.

In addition, notes 9 and 17 to the financial statements include the Bank's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

Having reviewed the Bank's forecasts, projections and other relevant evidence, the directors have a reasonable expectation that the Bank will continue in operational existence for the foreseeable future. Accordingly, the financial statements of the Bank have been prepared on a going concern basis.

# Report of the directors

### DIVIDENDS

The directors declared an ordinary dividend of £762m (2018: £470m) to The Royal Bank of Scotland International (Holdings) Limited and a preference dividend of £10m (2018: Nil) to Royal Bank of Scotland Group Plc.

### REGULATION

The Company is licensed in Jersey under Banking Business (Jersey) Law 1991, as amended to conduct deposit taking business, and the Financial Services (Jersey) Law 1998 to conduct fund services business, general insurance mediation business, investment business and money services business, under classes A, C, Q, X, Z, DC and 2 of this law. The Company operates in different jurisdictions through its branches and is subject to the following laws and regulations:

Guernsey
- Banking Supervision (Bailiwick of Guernsey) Law 1994;
- The Insurance Managers and Insurance Intermediaries (Bailiwick of Guernsey) Law 2002;

Isle of Man
- Financial Services Act 2008;
- Insurance Act 2008.

Gibraltar
- Financial Services Act 2019;

Luxembourg
- Law of 5 April 1993 of the Financial Sector.

London
- Financial Services & Markets Act 2000;

### POST BALANCE SHEET EVENTS

There have been no significant events between the year end and the date of approval of the financial statements which would require a change or additional disclosure in the financial statements.

### AUDITOR

The auditor, Ernst & Young LLP, has expressed its willingness to continue as auditor and will continue in office in accordance with the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007.

By order of the Board:

A M McLaughlin
Director
Date: 13 February 2020

L A Cleary
Director
Date: 13 February 2020

## Statement of directors' responsibilities

The directors are responsible for preparing the financial statements in accordance with applicable law and regulation.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). The financial statements are required by law to give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements the directors are required to:

- properly select and apply accounting policies;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with the specific requirements in IFRS are insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Company's financial position and financial performance; and
- make an assessment of the Company's ability to continue as a going concern.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies (Jersey) Law 1991, the Banking Business (Jersey) Law 1991, the Financial Services (General Insurance Mediation Business (Accounts, Audits, Reports and Solvency)) (Jersey) Order 2005, the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007 and the Financial Services (Fund Services Business (Accounts, Audits and Reports)) (Jersey) Order 2007. They are responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in Jersey governing the preparation and dissemination of financial information differs from legislation in other jurisdictions.

The directors are also responsible for compliance with the Banking Business (Jersey) Law 1991, the Financial Services (Jersey) Law 1998 and their Codes of Practice.

By order of the Board:

A M McLaughlin
Director
Date: 13 February 2020

L A Cleary
Director
Date: 13 February 2020

# Independent auditor's report to the members of The Royal Bank of Scotland International Limited

## Opinion

We have audited the financial statements of The Royal Bank of Scotland International Limited (the "Company") for the year ended 31 December 2019 which comprise the Income Statement, the Statement of Comprehensive Income, the Balance Sheet, the Statement of Changes in Equity, the Cash Flow Statement and the related notes 1 to 21, including a summary of significant accounting policies. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards.

In our opinion, the financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2019 and of its profit for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards;
- have been properly prepared in accordance with the requirements of the Companies (Jersey) Law 1991;
- have been prepared in accordance with the requirements of the Banking Business (Jersey) Law 1991;
- have been prepared in accordance with the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007;
- have been prepared in accordance with the Financial Services (Fund Services Business (Accounts, Audits and Reports)) (Jersey) Order 2007; and
- have been prepared in accordance with the requirements of the Financial Services (General Insurance Mediation Business (Accounts, Audits, Reports and Solvency)) (Jersey) Order 2005.

## Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report below. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

## Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the Company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

## Other information

The other information comprises the information included in the Report of the Directors, other than the financial statements and our auditor's report thereon. The directors are responsible for the other information.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in this report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of the other information, we are required to report that fact.

We have nothing to report in this regard.

## Matters on which we are required to report by exception

We have nothing to report in respect of the following matters in relation to which the Companies (Jersey) Law 1991 requires us to report to you if, in our opinion:

- proper accounting records have not been kept by the Company, or proper returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the Company's accounting records and returns; or
- we have not received all the information and explanations we require for our audit.

# Independent auditor's report to the members of The Royal Bank of Scotland International Limited

### Responsibilities of directors

As explained more fully in the statement of directors' responsibilities set out on page 6, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

### Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at https://www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

### Use of our report

This report is made solely to the Company's members, as a body, in accordance with Article 113A of the Companies (Jersey) Law 1991. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

David Robert John Moore ACA
for and on behalf of Ernst & Young LLP
Jersey, Channel Islands

13 February 2020

Notes:

1. The maintenance and integrity of the Royal Bank of Scotland International Limited's web site is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the web site.
2. Legislation in the Jersey governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

# Income statement for the financial year ended 31 December 2019

| Continuing operations | Note | 2019 £m | 2018 £m |
|---|---|---|---|
| Interest receivable | | 563 | 487 |
| Interest payable | | (92) | (66) |
| **Net interest income** | 1 | 471 | 421 |
| Fees and commissions receivable | | 91 | 71 |
| Fees and commissions payable | | (1) | (21) |
| Other operating income/(expenses) | | 2 | (1) |
| **Non-interest income** | 2 | 92 | 49 |
| **Total income** | | 563 | 470 |
| **Operating expenses** | 3 | (226) | (199) |
| **Operating profit before impairment gains** | | 337 | 271 |
| Impairment (losses)/gains | 9 | (2) | 1 |
| **Operating profit before tax** | | 335 | 272 |
| Tax charge | 5 | (42) | (34) |
| **Profit for the year** | | 293 | 238 |

The accompanying accounting policies and notes form an integral part of these financial statements.

# Statement of comprehensive income for the financial year ended 31 December 2019

| | Note | 2019 £m | 2018 £m |
|---|---|---|---|
| **Profit for the year** | | 293 | 238 |
| **Items that will not be classified subsequently to profit and loss:** | | | |
| Actuarial gains on defined benefit schemes | 4 | - | 18 |
| Deferred taxation on actuarial movements on defined benefit schemes | 5 | - | (5) |
| Fair value through other comprehensive income (FVOCI) financial assets | | - | 1 |
| **Other comprehensive gains for the year after tax** | | - | 14 |
| **Total comprehensive income for the year** | | 293 | 252 |

The accompanying accounting policies and notes form an integral part of these financial statements.

# Balance sheet as at 31 December 2019

| | Note | 2019 £m | 2018 £m |
|---|---|---|---|
| **Assets** | | | |
| Cash and balances at central banks | 8 | 10,617 | 10,437 |
| Derivatives | 6 | 36 | 26 |
| Loans to banks - amortised cost | 8 | 1,337 | 483 |
| Loans to customers - amortised cost | 8 | 14,115 | 12,621 |
| Other loans | 8 | - | 2 |
| Amounts due from holding companies and fellow subsidiaries | 8 | 1,056 | 3,037 |
| Other financial assets | 7 | 5,069 | 3,731 |
| Intangible assets | 11 | 7 | 8 |
| Other assets | 12 | 247 | 104 |
| **Total assets** | | 32,484 | 30,449 |
| | | | |
| **Liabilities** | | | |
| Bank deposits | 8 | 14 | 2 |
| Customer deposits | 8 | 30,137 | 25,998 |
| Derivatives | 6 | 56 | 37 |
| Other financial liabilities | 8 | - | 2 |
| Amounts due to holding companies and fellow subsidiaries | 8 | 279 | 2,282 |
| Other liabilities | 13 | 160 | 107 |
| **Total liabilities** | | 30,646 | 28,428 |
| | | | |
| **Owners' equity** | | 1,838 | 2,021 |
| | | | |
| **Total liabilities and equity** | | 32,484 | 30,449 |
| | | | |
| **Memorandum items** | | | |
| **Contingent liabilities and commitments** | 18 | 6,610 | 15,102 |

The accompanying accounting policies and notes form an integral part of these financial statements.

The financial statements were approved and authorised for issue by the Board of Directors on 13 February 2020 and signed on its behalf by:

A M McLaughlin
Director

L A Cleary
Director

# Statement of changes in equity for the financial year ended 31 December 2019

| | Note | 2019 £m | 2018 £m |
|---|---|---|---|
| **Called up share capital** | | | |
| At 1 January and 31 December | 14 | 97 | 97 |
| | | | |
| **Paid-in equity** | | | |
| At 1 January | | - | - |
| Additional Tier 1 capital notes issued | | 300 | - |
| At 31 December | 15 | 300 | - |
| | | | |
| **Share premium** | | | |
| At 1 January and 31 December | | 5 | 5 |
| | | | |
| **Retained earnings** | | | |
| At 1 January | | 1,919 | 2,141 |
| Implementation of IFRS 9 on 1 January 2018 | | - | (3) |
| Implementation of IFRS 16 on 1 January 2019 (1) | | (4) | - |
| Actuarial gains recognised in defined benefit schemes | 4 | - | 18 |
| Deferred taxation on actuarial movements recognised on defined benefit schemes | 5 | - | (5) |
| Dividends paid | | | |
| - ordinary dividend | | (762) | (470) |
| - preference dividend | | (10) | - |
| Profit attributable to ordinary shareholders and other equity owners | | 293 | 238 |
| At 31 December | | 1,436 | 1,919 |
| | | | |
| **Owners' equity at 31 December** | | 1,838 | 2,021 |

Notes:
(1) Refer to Note 16 for further information on the impact of IFRS 16.

The accompanying accounting policies and notes form an integral part of these financial statements.

# Cash flow statement for the financial year ended 31 December 2019

| | Note | 2019 £m | 2018 £m |
|---|---|---|---|
| **Cash flows from Operating activities** | | | |
| Operating profit before tax | | 335 | 272 |
| Amortisation of deferred fees | | - | (9) |
| Impairment losses/(releases) on loans to banks and customers | | 2 | (1) |
| Defined benefit pension schemes | | (83) | (2) |
| Depreciation, amortisation and impairment of property, plant, equipment, goodwill and intangibles | | 11 | 6 |
| Elimination of foreign exchange differences | | 277 | (65) |
| Other non - cash items | | (42) | (7) |
| Net cash flows from trading activities | | 500 | 194 |
| Increase in loans and advances to banks and customers | | (1,484) | (4,749) |
| Decrease in amounts due from holding companies and fellow subsidiaries | | 49 | 21,971 |
| Decrease in other financial assets | | - | 39 |
| Decrease in other assets | | 4 | 22 |
| Decrease in derivative assets and liabilities | | 9 | 10 |
| Increase/(decrease) in deposits by banks and customers | | 4,151 | (1,965) |
| Increase/(decrease) in amounts due to holding companies and fellow subsidiaries | | (2,003) | 1,896 |
| (Decrease)/increase in other liabilities | | (5) | 15 |
| Changes in operating assets and liabilities | | 721 | 17,239 |
| Income taxes paid | | (38) | (24) |
| Net cash flows from operating activities [1] | | 1,183 | 17,409 |
| **Cash flows from investing activities** | | | |
| Sale and maturity of securities | | 983 | - |
| Purchase of securities | | (2,317) | (3,729) |
| Sale of property, plant and equipment | | 2 | 2 |
| Purchase of property, plant and equipment | | (27) | (12) |
| Net cash flows used in investing activities | | (1,359) | (3,739) |
| **Cash flows from financing activities** | | | |
| Issue of Additional Tier 1 capital notes | | 300 | - |
| Dividends paid | | (772) | (470) |
| Net cash flows used in financing activities | | (472) | (470) |
| Effects of exchange on cash & cash equivalents | | (277) | 65 |
| Net (decrease)/increase in cash and cash equivalents | | (925) | 13,265 |
| Cash and cash equivalents at 1 January | 20 | 13,812 | 547 |
| Cash and cash equivalents at 31 December | 20 | 12,887 | 13,812 |

Note:

(1) Includes interest received of £511m (2018 - £417m) and interest paid of £42m (2018 - £52m).
Cash flows from operating activities also include interest and repayment of lease liabilities of £4m (2018 - nil).

(2) Debt securities of £39m which were included in cash and cash equivalents in 2018 have been reclassified to Net cash flows from operating activities.

The accompanying accounting policies and notes form an integral part of these financial statements.

# Accounting policies

## 1. Presentation of accounts

The accounts, set out on pages 9 to 63 including these accounting policies on pages 14 to 19 and Risk management sections on pages 37 to 61, are prepared on a going concern basis (see the Report of the directors, page 5) and in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IASB) and interpretations as issued by the IFRS Interpretations Committee of the IASB (together IFRS). The significant accounting policies and related judgments are set out below.

The Company is incorporated and registered in Jersey, Channel Islands (Registration number - 2304). The Bank's registered and head office is Royal Bank House, 71 Bath Street, St Helier, Jersey, JE4 8PJ.

The accounts are presented in the functional currency, pounds sterling.

With the exception of certain financial instruments as described in Accounting policies 12 and 18, the accounts are presented on a historical cost basis.

**Accounting policy changes effective 1 January 2019**

**Adoption of IFRS 16**

Refer to Accounting policy 9 and Note 16 for details of the adoption of IFRS 16.

**Other amendments to IFRS**

IAS 19 'Employee Benefits' was amended by IASB in February 2018 to clarify the need to update assumptions whenever there is a plan amendment, curtailment or settlement. This amendment has not affected the accounts.

Presentation of interest in suspense recoveries- In March 2019 the IFRS Interpretations Committee (IFRIC) issued an agenda decision on the presentation of unrecognised interest when a credit-impaired financial asset (commonly referred to as a 'Stage 3' financial asset) is subsequently paid in full or is no longer credit-impaired. This concluded that the difference arising from the additional interest recovered must be recognised as a reversal of impairment rather than within interest revenue. This affects both recognition and the reversal of the expected credit loss (ECL) allowance.

The Company changed its accounting policy in line with the IFRIC decision. Hence, the gross carrying amount of the financial assets within the scope of the provisions of the decision, as well as the associated ECL allowance on the balance sheet, have been adjusted by £6m and the comparative period restated by £6m with no effect on the income statement or equity.

In addition, until 1 January 2019, interest in suspense recoveries were presented as a component of interest receivable within Net interest income. From 1 January 2019 interest in suspense recoveries is presented within impairment losses and amounted to £0.3m for the year ended 31 December 2019. Comparatives have not been restated on the grounds of materiality.

## 2. Revenue recognition

Interest income or expense relates to financial instruments measured at amortised cost and debt instruments classified as fair value through OCI using the effective interest rate method, the effective part of any related accounting hedging instruments, and finance lease income recognised at a constant periodic rate of return before tax on the net investment. Negative effective interest accruing to financial assets is presented in interest payable. Other interest relating to financial instruments measured at fair value is recognised as part of the movement in fair value.

Fees in respect of services are recognised as the right to consideration accrues through the performance of each distinct service obligation to the customer. The arrangements are generally contractual and the cost of providing the service is incurred as the service is rendered. The pricing base is usually known and always determinable.

## 3. Employee benefits

Short-term employee benefits, such as salaries, paid absences, and other benefits are accounted for on an accruals basis over the period in which the employees provide the related services. Employees may receive variable compensation satisfied by cash, by debt instruments issued by the RBS Group or by RBSG plc shares. The Company operates a number of share-based compensation schemes under which it awards RBSG plc shares and share options to its employees. Such awards are generally subject to vesting conditions.

Variable compensation that is settled in cash or debt instruments is charged to profit or loss on a straight-line basis over the vesting period, taking account of forfeiture and clawback criteria.

Contributions to defined contribution pension schemes are recognised in profit or loss as employee service costs accrue.

For defined benefit pension schemes, the net of the recognisable scheme assets and obligations is reported in the balance sheet. The defined benefit obligation is measured on an actuarial basis. The charge to profit or loss for pension costs (mainly the service cost and the net interest on the net defined benefit asset or liability) is recognised in operating expenses.

Actuarial gains and losses (i.e. gains and/or losses on re-measuring the net defined benefit asset or liability) are recognised in other comprehensive income in full in the period in which they arise. The difference between scheme assets and scheme liabilities, the net defined benefit asset or liability, is recognised in the balance sheet subject to the asset ceiling test which requires the net defined benefit surplus to be limited to the present value of any economic benefits available to the company in the form of refunds from the plan or reduced contributions to it.

The charge to profit or loss for pension costs (mainly the service cost and the net interest on the net defined benefit asset or liability) is recognised in operating expenses.

## 4. Property, plant and equipment

Items of property, plant and equipment are stated at cost less accumulated depreciation and accumulated impairment losses. Where an item of property, plant and equipment comprises major components having different useful lives, they are accounted for separately.

Depreciation is charged to the income statement on a straight-line basis so as to write off the depreciable amount of property, plant and equipment (including assets owned and let on operating leases) over their estimated useful lives. The depreciable amount is the cost of an asset less its residual value. Freehold land is not depreciated.

The estimated useful lives are as follows:

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

The residual value and useful life of property, plant and equipment are reviewed at each balance sheet date and updated for any changes to previous estimates.

### 5. Intangible assets and goodwill

Intangible assets acquired by the Company are stated at cost less accumulated amortisation and impairment losses. Amortisation is charged to profit or loss over the assets' estimated useful economic lives using methods that best reflect the pattern of economic benefits and is included in Depreciation and amortisation. These estimated useful economic lives are:

| | |
|---|---|
| Computer software | 3 to 12 years |
| Other acquired intangibles | 5 to 10 years |

Expenditure on internally generated goodwill and brands is written-off as incurred. Direct costs relating to the development of internal-use computer software are capitalised once technical feasibility and economic viability have been established. These costs include payroll, the costs of materials and services, and directly attributable overheads. Capitalisation of costs ceases when the software is capable of operating as intended. During and after development, accumulated costs are reviewed for impairment against the benefits that the software is expected to generate. Costs incurred prior to the establishment of technical feasibility and economic viability are expensed as incurred as are all training costs and general overheads. The costs of licences to use computer software that are expected to generate economic benefits beyond one year are also capitalised.

Other intangibles, including goodwill, are measured at cost (being the excess of the aggregate of the consideration transferred and the amount recognised for non-controlling interests) and any previous interest held over the net identifiable assets acquired and liabilities assumed. After initial recognition, other intangibles including goodwill are measured at cost less any accumulated impairment losses. For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Bank's cash-generating units that are expected to benefit from the combination, irrespective of whether other assets or liabilities of the acquire are assigned to those units.

### 6. Asset transfers under common control

Business combinations involving businesses under common control are business combinations in which all of the combining businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory. This will include Bank restructurings and reorganisations such as the transfer of subsidiaries or businesses between entities within a Bank.

IFRS 3 does not address the methods of accounting that may be appropriate when a business combination involves entities under common control. Accordingly management are able to develop an accounting policy that is relevant and reliable in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

The following accounting policies have been adopted for business combinations under common control:

- Assets and liabilities of the combining businesses are reflected at their carrying amounts;
- No goodwill is recognised because of the combination. Any difference between the consideration paid/transferred and the business acquired is reflected in equity; and
- No restatement of comparatives occurs prior to the combination under common control.

### 7. Impairment of intangible assets, rights of use assets and property, plant and equipment

At each balance sheet date, the Company assesses whether there is any indication that its intangible assets, right of use assets or property, plant and equipment are impaired. If any such indication exists, the Company estimates the recoverable amount of the asset and the impairment loss if any. Goodwill is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired.

The recoverable amount of an asset that does not generate cash flows that are independent from those of other assets or groups of assets, is determined as part of the cash-generating unit to which the asset belongs. A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. For the purposes of impairment testing, goodwill acquired in a business combination is allocated to each of the Company's cash-generating units or groups of cash-generating units expected to benefit from the combination. The recoverable amount of an asset or cash-generating unit is the higher of its fair value less cost to sell or its value in use. Value in use is the present value of future cash flows from the asset or cash-generating unit discounted at a rate that reflects market interest rates adjusted for risks specific to the asset or cash-generating unit that have not been taken into account in estimating future cash flows.

An impairment loss is recognised if the recoverable amount of an intangible or tangible asset is less than its carrying value. The carrying value of the asset is reduced by the amount of the loss and a charge recognised in profit or loss. A reversal of an impairment loss on intangible assets (excluding goodwill) or property, plant and equipment can be recognised when an increase in service potential arises provided the increased carrying value is not greater than it would have been had no impairment loss been recognised. Impairment losses on goodwill are not reversed.

### 8. Foreign currencies

Transactions in foreign currencies are recorded in the functional currency at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the relevant functional currency at the foreign exchange rates ruling at the balance sheet date. Foreign exchange differences arising on the settlement of foreign currency transactions and from the translation of monetary assets and liabilities are reported in income from trading activities except for differences arising on cash flow hedges (see Accounting policy 18).

Non-monetary items denominated in foreign currencies that are stated at fair value are translated into the relevant functional currency at the foreign exchange rates ruling at the dates the values are determined. Translation differences arising on non-monetary items measured at fair value are recognised in profit or loss except for differences arising on nonmonetary financial assets classified as fair value through OCI, for example equity shares, which are recognised in other comprehensive income unless the asset is the hedged item in a fair value hedge.

Assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into Sterling at foreign exchange rates ruling at the balance sheet date. Income and expenses of foreign operations are translated into Sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions. Foreign exchange differences arising on translation of foreign operations are recognised in other comprehensive income. The amount accumulated in equity is reclassified from equity to profit or loss on disposal of a foreign operation.

### 9. Leases

The Company has adopted IFRS 16 'Leases' with effect from 1 January 2019, replacing IAS 17 'Leases'. The Company has applied IFRS 16 on a modified retrospective basis without restating prior years. The effect is set out in Note 16.

#### As lessor

Finance lease contracts are those which transfer substantially all the risks and rewards of ownership of an asset to a customer. All other contracts with customers to lease assets are classified as operating leases.

Loans to customers include finance lease receivables measured at the net investment in the lease, comprising the minimum lease payments and any unguaranteed residual value discounted at the interest rate implicit in the lease. Interest receivable includes finance lease income recognised at a constant periodic rate of return before tax on the net investment. Unguaranteed residual values are subject to regular review; if there is a reduction in their value, income allocation is revised and any reduction in respect of amounts accrued is recognised immediately.

Rental income from operating leases is recognised in other operating income on a straight-line basis over the lease term unless another systematic basis better represents the time pattern of the asset's use. Operating lease assets are included within Property, plant and equipment and depreciated over their useful lives.

#### As lessee

On entering into a new lease contract, the Company recognises a right of use asset and a lease liability to pay future rentals. The liability is measured at the present value of future lease payments discounted at the applicable incremental borrowing rate. The right of use asset is depreciated over the shorter of the term of the lease and the useful economic life, subject to review for impairment.

Short term and low value leased assets are expensed on a systematic basis.

### 10. Provisions and contingent liabilities

The Company recognises a provision for a present obligation resulting from a past event when it is more likely than not that it will be required to transfer economic benefits to settle the obligation and the amount of the obligation can be estimated reliably.

Provision is made for restructuring costs, including the costs of redundancy, when the Bank has a constructive obligation to restructure. An obligation exists when the Bank has a detailed formal plan for the restructuring and has raised a valid expectation in those affected by starting to implement the plan or by announcing its main features.

The Company recognises any onerous cost of the present obligation under a contract as a provision. An onerous cost is the unavoidable cost of meeting the Company's contractual obligations that exceed the expected economic benefits. When the Company vacates a leasehold property, the right of use asset would be tested for impairment and a provision may be recognised for the ancillary occupancy costs, such as rates.

Contingent liabilities are possible obligations arising from past events, whose existence will be confirmed only by uncertain future events, or present obligations arising from past events that are not recognised because either an outflow of economic benefits is not probable or the amount of the obligation cannot be reliably measured. Contingent liabilities are not recognised if not probable but information about them is disclosed unless the possibility of any outflow of economic benefits in settlement is remote.

### 11. Tax

Income tax expense or income, comprising current tax and deferred tax, is recorded in the income statement except income tax on items recognised outside profit or loss which is credited or charged to other comprehensive income or to equity as appropriate. The tax consequences of servicing equity instruments are recognised in income statement.

Current tax is income tax payable or recoverable in respect of the taxable profit or loss for the year arising in profit or loss, other comprehensive income or equity. Provision is made for current tax at rates enacted or substantively enacted at the balance sheet date.

Deferred tax is the tax expected to be payable or recoverable in respect of temporary differences between the carrying amount of an asset or liability for accounting purposes and its carrying amount for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent their recovery is probable.

Deferred tax is not recognised on temporary differences that arise from initial recognition of an asset or a liability in a transaction (other than a business combination) that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax is calculated using tax rates expected to apply in the periods when the assets will be realised or the liabilities settled, based on tax rates and laws enacted, or substantively enacted, at the balance sheet date.

Deferred tax assets and liabilities are offset where the Company has a legally enforceable right to offset and where they relate to income taxes levied by the same taxation authority either on an individual RBS Group company or on RBS Group companies in the same tax group that intend, in future periods, to settle current tax liabilities and assets on a net basis or on a gross basis simultaneously.

Accounting for taxes is judgmental and carries a degree of uncertainty because tax law is subject to interpretation, which might be questioned by the relevant tax authority. The Company recognises the most likely current and deferred tax liability or asset, assessed for uncertainty using consistent judgments and estimates. Current and deferred tax assets are only recognised where their recovery is deemed probable and current and deferred tax liabilities are recognised at the amount that represents the best estimate of the probable outcome having regard to their acceptance by the tax authorities.

## 12. Financial instruments

Financial instruments are classified either by product, by business model or by reference to the IFRS default classification.

Classification by product relies on specific designation criteria which are applicable to certain classes of financial assets or circumstances where accounting mismatches would otherwise arise. Classification by business model reflects how the Company manages its financial assets to generate cash flows. A business model assessment determines if cash flows result from holding financial assets to collect the contractual cash flows; from selling those financial assets; or both.

The product classifications apply to financial assets that are either designated at fair value through profit or loss (DFV), or to equity investments designated as at fair value through other comprehensive income (FVOCI).

Financial assets may also be irrevocably designated at fair value through profit or loss upon initial recognition if such designation eliminates, or significantly reduces, accounting mismatch. In all other instances, fair value through profit or loss (MFVTPL) is the default classification and measurement category for financial assets.

Regular way purchases of financial assets classified as amortised cost, are recognised on the settlement date; all other regular way transactions in financial assets are recognised on the trade date.

Business model assessment of assets is made at portfolio level, being the level at which they are managed to achieve a predefined business objective. This is expected to result in the most consistent classification of assets because it aligns with the stated objectives of the portfolio, its risk management, manager's remuneration and the ability to monitor sales of assets from a portfolio.

Most financial assets are within 'held to collect' business models, and have the contractual cash flows that comprise solely payments of principal and interest and therefore measured at amortised cost. Certain financial assets are managed under a business model of both to 'held to collect and sell' and have contractual cash flows comprising solely of payments of principal and interest, are measured at fair value through other comprehensive income ('FVOCI').

A debt instrument is normally measured at FVOCI if both of the following conditions are met:

- The instrument is held within a business model whose objective is both to hold assets to collect contractual cash flows and selling financial assets; and
- The contractual terms of the financial asset are solely payments of principle and interest on the outstanding balance.

A debt instrument that is not measured at amortised cost or at FVOCI must be measured at FVPL.

The contractual terms of a facility, any leverage features, prepayment and extension terms, and triggers that might reset the effective rate of interest, are considered in determining whether cash flows comprise solely payments of principal and interest.

All financial instruments are measured at fair value on initial recognition.

All liabilities not subsequently measured at fair value are measured at amortised cost.

## 13. Impairment: expected credit losses

At each balance sheet date each financial asset or portfolio of loans measured at amortised cost or at fair value through other comprehensive income, issued financial guarantee and loan commitment is assessed for impairment and presented as impairments in the income statement. Loss allowances are forward looking, based on 12 month expected credit losses where there has not been a significant increase in credit risk (SICR) rating (refer Note 17 for details), otherwise allowances are based on lifetime expected losses.

Expected credit losses (ECL) are a probability-weighted estimate of credit losses. The probability is determined by the risk of default which is applied to the cash flow estimates. In the absence of a change in credit rating, allowances are recognised when there is reduction in the net present value of expected cash flows. On a significant increase in credit risk, allowances are recognised without a change in the expected cash flows, although typically expected cash flows do change also; and expected credit losses are adjusted from 12 month to lifetime expectations.

Judgement is exercised as follows:

- Models – in certain low default portfolios, Basel parameter estimates are also applied for IFRS 9.
- Non-modelled portfolios, RBSI Retail remains Basel standardised for Risk Weighted Assets, therefore modelled Probability of Default (PDs) and Loss Given Default (LGDs) are not available for calculating stage 1 and stage 2 ECLs. Instead this is undertaken by sourcing the equivalent product PD & LGD from within NatWest UK, which was identified as the closest comparable portfolio to RBSI Retail. The PD and LGD benchmarks are then used, along with the known exposure, to calculate an account level ECL.
- Multiple economic scenarios (MES) – the central, or base, scenario is most critical to the ECL calculation, independent of the method used to generate a range of alternative outcomes and their probabilities.
- Significant increase in credit risk - IFRS 9 requires that at each reporting date, an entity shall assess whether the credit risk on an account has increased significantly since initial recognition. Part of this assessment requires a comparison to be made between the current lifetime PD (i.e. the current probability of default over the remaining lifetime) with the equivalent lifetime PD as determined at the date of initial recognition.

On restructuring a financial asset without causing derecognition of the original asset the revised cash flows are used in re-estimating the credit loss. Where restructuring causes derecognition of the original financial asset, the fair value of the replacement asset is used as the closing cash flow of the original asset.

Impaired loans are written off and therefore derecognised from the balance sheet when the Company concludes that there is no longer any realistic prospect of recovery of part, or all, of the loan. For loans that are individually assessed for impairment, the timing of the write off is determined on a case by case basis. Such loans are reviewed regularly and write off will be prompted by bankruptcy, insolvency, renegotiation and similar events.

The typical time frames from initial impairment to write off for Bank's collectively-assessed portfolios are:

- Retail mortgages: write off usually occurs within five years, or when an account is closed if earlier.
- Overdrafts and other unsecured loans: write off occurs within six years
- Commercial loans: write offs are determined in the light of individual circumstances; the period does not typically exceed five years.
- Business loans are generally written off within five years.

### 14. Derecognition

A financial asset is derecognised when the contractual right to receive cash flows from the asset has expired or when it has been transferred and the transfer qualifies for derecognition. Conversely, an asset is not derecognised by a contract under which the Company retains substantially all the risks and rewards of ownership. If substantially all the risks and rewards have been neither retained nor transferred, the Company does not derecognise an asset over which it has retained control but limits its recognition to the extent of its continuing involvement.

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

### 15. Sale and repurchase transactions

Securities subject to sale and repurchase agreement under which substantially all the risks and rewards of ownership are retained by the Company continue to be shown on the balance sheet and the sale proceeds recorded as a financial liability. Securities acquired in a reverse sale and repurchase transaction under which the Company is not exposed to substantially all the risks and rewards of ownership are not recognised on the balance sheet and the consideration paid is recorded as a financial asset. Where Collateral supporting the transaction is received in the form of cash, deposit is recorded. Sale and repurchase transactions that are not accounted for at fair value through profit or loss are measured at amortised cost. The difference between the consideration paid or received and the repurchase or resale price is treated as interest and recognised in interest income or interest expense over the life of the transaction.

### 16. Netting

Financial assets and financial liabilities are offset and the net amounts presented in the balance sheet when, and only when, the Company has a legally enforceable right to set off the recognised amounts and it intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. The Company is party to a number of arrangements, including master netting agreements, that give it the right to offset financial assets and financial liabilities but where it does not intend to settle the amounts net or simultaneously the assets and liabilities concerned are presented gross.

### 17. Capital instruments

The Bank classifies a financial instrument that it issues as a liability if it is a contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities on potentially unfavourable terms and as equity if it evidences a residual interest in the assets of the Bank after the deduction of liabilities.

### 18. Derivatives and hedging

Derivative financial instruments are initially recognised, and subsequently measured, at fair value. The Bank's approach to determining the fair value of financial instruments is set out in the Critical accounting policies and key sources of estimation uncertainty entitled Fair value - financial instruments; further details are given in Note 8 on the accounts. A derivative embedded in a financial liability contract is accounted for as a stand-alone derivative if its economic characteristics are not closely related to the economic characteristics of the host contract; unless the entire contract is measured at fair value with changes in fair value recognised in profit or loss.

Gains and losses arising from changes in the fair value of derivatives that are not the hedging instrument in a qualifying hedge are recognised as they arise in profit or loss. Gains and losses are recorded in Income from trading activities except for gains and losses on those derivatives that are managed together with financial instruments designated at fair value; these gains and losses are included in Other operating income. The Company enters into two types of hedge relationship: hedges of changes in the fair value of a recognised asset or liability or unrecognised firm commitment (fair value hedges) and hedges of the variability in cash flows from a recognised asset or liability or a highly probable forecast transaction (cash flow hedges).

Hedge relationships are formally designated and documented at inception in line with the requirements of IAS 39 Financial instruments – Recognition and measurement.. The documentation identifies the hedged item, the hedging instrument and details the risk that is being hedged and the way in which effectiveness will be assessed at inception and during the period of the hedge.

If the hedge is not highly effective in offsetting changes in fair values or cash flows attributable to the hedged risk, consistent with the documented risk management strategy, hedge accounting is discontinued. Hedge accounting is also discontinued if RBS Group revokes the designation of a hedge relationship.

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

*Cash flow hedge -* in a cash flow hedge, the effective portion of the gain or loss on the hedging instrument is recognised in other comprehensive income and the ineffective portion in profit or loss. When the forecast transaction results in the recognition of a financial asset or financial liability, the cumulative gain or loss is reclassified from equity to profit or loss in the same periods in which the hedged forecast cash flows affect profit or loss. Otherwise the cumulative gain or loss is removed from equity and recognised in profit or loss at the same time as the hedged transaction. Hedge accounting is discontinued if the hedge no longer meets the criteria for hedge accounting; if the hedging instrument expires or is sold, terminated or exercised; if the forecast transaction is no longer expected to occur; or if hedge designation is revoked. On the discontinuation of hedge accounting (except where a forecast transaction is no longer expected to occur), the cumulative unrealised gain or loss is reclassified from equity to profit or loss when the hedged cash flows occur or, if the forecast transaction results in the recognition of a financial asset or financial liability, when the hedged forecast cash flows affect profit or loss. Where a forecast transaction is no longer expected to occur, the cumulative unrealised gain or loss is reclassified from equity to profit or loss immediately.

### 19. Cash and cash equivalents

In the cash flow statement, cash and cash equivalents comprises cash and deposits with banks with an original maturity of less than three months together with short-term highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risk of change in value.

### 20. Assets under administration

Assets and liabilities held in a fiduciary capacity are not included in these financial statements.

### Critical accounting policies and key sources of estimation uncertainty

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

The judgements and assumptions involved in the Company'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 Company would affect its reported results.

| Critical accounting policy | Note |
|---|---|
| Amortisation of fees | 1 |
| Pensions | 4 |
| Fair value - financial instruments | 8 |
| Loan impairment provisions | 9 |
| Provisions for liabilities and charges | 13 |

### Accounting developments

#### International Financial Reporting Standards

A number of IFRSs and amendments to IFRS were in issue at 31 December 2019 that would affect the Company from 1 January 2020 or later:

- The amendments to IAS 1 'Presentation of Financial Statements' and IAS 8 'Accounting Policy, Changes in Accounting Estimates and Errors' on the definition of material were issued in October 2018 and are effective for annual periods beginning on or after 1 January 2020 with earlier application permitted. The amendments are aimed at improving the understanding of the existing requirements rather than to significantly impact current materiality judgements. They provide a new definition of material which shall be used to assess whether information, either individually or in combination with other information, is material in the context of the financial statements.
- The amendments to IFRS 3 'Business Combinations' which clarify the definition of a Business were issued in October 2018, are effective for annual reporting periods beginning on or after 1 January 2020 and apply prospectively with earlier application permitted. They clarify the minimum requirements for a business; remove the assessment of whether market participants are capable of replacing any missing elements; add guidance to help entities assess whether an acquired process is substantive; narrow the definitions of a business and of outputs; and introduce an optional fair value concentration test.
- Effective in 2022 - IFRS 17 'Insurance contracts' was issued in May 2017 to replace IFRS 4 and to establish a comprehensive standard for inceptors of insurance policies. The effective date is 1 January 2021, subject to IASB's approval of a deferral until 1 January 2022.

The Company is assessing the effect of adopting these standards on its financial statements.

## 1. Net interest income

| | 2019 £m | 2018 £m |
|---|---|---|
| Interest receivable on assets: | | |
| Loans to banks - amortised cost | 89 | 20 |
| Loans to customers - amortised cost | 379 | 293 |
| Amounts due from holding company and fellow subsidiaries | 22 | 142 |
| Other financial assets- Debt Securities | 46 | 5 |
| Interest receivable on liabilities: | | |
| Customer deposits | 27 | 27 |
| Interest receivable (1) | 563 | 487 |
| Interest payable on liabilities: | | |
| Bank deposits - amortised cost | (2) | (12) |
| Customer deposits | (56) | (35) |
| Lease liabilities | (1) | - |
| Amounts due to holding company and fellow subsidiaries | (15) | (7) |
| Interest payable on assets: | | |
| Loans to banks - amortised cost | (18) | (12) |
| Interest payable (1) | (92) | (66) |
| Net interest income | 471 | 421 |

Note:

(1) Negative interest on loans is classed as interest payable and on customer deposits is classed as interest receivable.

Interest income on financial instruments measured at amortised cost and debt instruments classified as fair value through OCI is measured using the effective interest rate which allocates the interest income or interest expense over the expected life of the asset or liability at the rate that exactly discounts all estimated future cash flows to equal the instrument's initial carrying amount. Calculation of the effective interest rate takes into account fees payable or receivable that are an integral part of the instrument's yield, premiums or discounts on acquisition or issue, early redemption fees and transaction costs. All contractual terms of a financial instrument are considered when estimating future cash flows. Finance lease income included in interest receivable was £5.04m (2018: £5.30m).

**Critical accounting policies: Amortisation of fees**

The Bank amortises the loan arrangement fees over the contractual life of the loan for the fees above £50k. If the arrangement fee is less than £50k, the behavioural life of each portfolio is used to amortise the fees as this is considered more appropriate measure.

The average behavioural life of 33 months was used to amortise the fees below £50k in 2019 (2018: 33 months).

The average behaviour life is calculated based on the contractual life of the loans and judgement is applied to determine the appropriate length of time over which fees should be deferred and hence booked into the Income statement. The Board does not believe there is a significant risk of a material adjustment as a result of possible changes in the length of the behaviour life. This is broadly split into 4 areas being: Financial and Corporate services, Funds, Real Estate & Corporate and Commercial.

The average behavioural lives of these four areas are:

| | |
|---|---|
| Financial and Corporate services years | 24 months (2018: 24 months) |
| Funds | 20 months (2018: 20 months) |
| Real Estate | 33 months (2018: 33 months) |
| Corporate and Commercial | 54 months (2018: 54 months) |

Interest receivable on loans to customers includes amortisation of arrangement fees of £42m (2018: £40m).

## 2. Non-interest income

| | 2019 £m | 2018 £m |
|---|---|---|
| Fees and commissions receivable | | |
| - Payment Services | 25 | 20 |
| - Credit & Debit Card Fees | 2 | 1 |
| - Lending - (Credit Facilities) | 30 | 18 |
| - Trade Finance | 4 | 3 |
| - Investment Management | 4 | 4 |
| - Other services | 4 | 2 |
| Other commissions (1) | 22 | 23 |
| Fees and commissions payable (2) | (1) | (21) |
| Other operating income/(expenses) | 2 | (1) |
| Total non interest income | 92 | 49 |

Note:

(1) Other commissions includes dealing profits.

(2) Fees and commissions payable pertaining to the year 2018 include £20m of breakage fees due to breaking of fixed term deposits with RBS Group.

## 3. Operating expenses

| | 2019 | 2018 |
|---|---|---|
| | £m | £m |
| **Staff costs** | | |
| Wages, salaries and other staff costs | 105 | 90 |
| Provision for restructuring costs (see note 13) | 4 | 4 |
| Pension costs: | | |
| - defined benefit schemes (see note 4) | 6 | 4 |
| - defined contribution schemes (see note 4) | 2 | - |
| | 117 | 98 |
| **Other expenses** | | |
| Premises and equipment | 15 | 18 |
| Provision for property costs (see note 13) | 1 | - |
| Release of provision for onerous leases (see note 13) | - | (1) |
| Administrative expenses (1) | 82 | 78 |
| | 98 | 95 |
| **Depreciation** | | |
| Property, plant and equipment depreciation (see note 10) | 10 | 5 |
| Intangible assets (see note 11) | 1 | 1 |
| | 11 | 6 |
| Total operating expenses | 226 | 199 |

Note:
(1) Administrative expenses include provisions for possible product redress and litigation.

| | 2019 | 2018 |
|---|---|---|
| **Auditor's remuneration** | £'000 | £'000 |
| Statutory audit work | 754 | 420 |
| Regulatory audit work | 129 | 48 |
| | 883 | 468 |

**Staff**
The average number of persons employed by the Company during the year, excluding temporary staff was 1,371 (2018: 1,365).

## 4. Pensions

**Defined contribution schemes**
The Company made contributions of £2,318k to its own defined contribution schemes in 2019 (2018: £285k).

Eligible employees of the Bank can participate in membership of RBS operated pension schemes. Employees are members of The Royal Bank of Scotland Retirement Savings Plan, a defined contribution pension scheme. Detailed disclosure of the RBS pension schemes is available in the RBS Annual Report and Accounts 2019.

**Defined benefit schemes**
The Company operates four defined benefit pension schemes. The most significant of these is The Royal Bank of Scotland International Pension Trust (RBSIPT). The assets of these schemes are independent of the Company's finances, and the schemes are each overseen by a board of trustees.

The RBSIPT operates under Jersey trust law and is managed and administered on behalf of its members in accordance with the terms of the trust deed, the scheme rules and the Jersey legislation and, where applicable, that of its constituent plans (primarily in Guernsey and the Isle of Man). There is no pension Scheme funding legislation in Jersey, Guernsey or the Isle of Man. However, statutory debt rules do apply in respect of the Isle of Man plan of the RBSIPT such that a debt may be due on an employer if it becomes insolvent; the scheme winds up; or, in the case of a multi-employer scheme, stops participating in the scheme while the scheme continues.

The RBSIPT's corporate trustee is RBS International Employees' Pension Trustees Limited ("RBSIEPTL"), a subsidiary of The Royal Bank of Scotland International (Holdings) Limited. RBSIEPTL is the legal owner of the RBSIPT's assets which are held separately from the assets of the Company.

The Board of RBSIEPTL comprises two trustee directors nominated by members selected from eligible active staff and pensioner members who apply; three directors appointed by the Company; and one independent Trustee. The Board is responsible for operating the scheme in line with its formal rules and pensions law.

It has a duty to act in the best interests of all scheme members, including pensioners and those who are no longer employed by the Company, but who still have benefits in the scheme.

The Company's UK scheme is a fully segregated section of The Royal Bank of Scotland Group Pension Fund. The section only provides benefits to employees of the Company. For further information on the Fund, please refer to the RBS Annual Report and Accounts 2019.

During the year, the assets and liabilities which includes two pension schemes of Isle of Man Bank Limited were transferred to the Company. The Isle of Man Bank Pension Fund ("IOMPF") and The Isle of Man Bank Widows' and Orphans' Fund ("IOMWO"), the assets of which are independent of the Company's finances.

## 4. Pensions (continued)

The schemes operate under Isle of Man trust law and are managed and administered on behalf of their members in accordance with the terms of the trust deed, the scheme rules and Isle of Man legislation.

The trustees of the schemes collectively own the scheme assets which are held separately from the assets of the Company. The Trustee body comprises three trustees nominated by the Company:- one representative of the pensioners; one representative of the recognised union in the Isle of Man and one independent trustee. The trustees are responsible for operating the schemes in line with its formal rules and pensions law. It has a duty to act in the best interests of all scheme members, including pensioners and those who are no longer employed by the Company but who still have benefits in the schemes.

**Investment strategy**

The assets of all the 4 schemes are invested in a diversified portfolio of quoted equities, government and corporate fixed-interest and index-linked bonds. The Scheme's equity holdings are held in passive pooled funds managed by State Street. The Trustee's investment benchmark is for the majority to be invested in global developed markets, with a small proportion invested in emerging markets.

| | 2019 | | | 2018 | | |
|---|---|---|---|---|---|---|
| **Major classes of plan assets as a weighted percentage of total plan assets of the schemes** | Quoted % | Unquoted % | Total % | Quoted % | Unquoted % | Total % |
| Equities | 25% | - | 25% | 31% | - | 31% |
| Index-linked bonds | 34% | - | 34% | 24% | - | 24% |
| Government fixed interest bonds | 16% | - | 16% | 19% | - | 19% |
| Corporate and other bonds | 18% | - | 18% | 12% | 2% | 14% |
| Hedge funds | - | - | - | - | - | - |
| Property | - | 3% | 3% | - | 4% | 4% |
| Derivatives | - | 1% | 1% | - | 2% | 2% |
| Cash and other assets | - | 3% | 3% | - | 6% | 6% |
| | 93% | 7% | 100% | 86% | 14% | 100% |

| | All schemes | | | |
|---|---|---|---|---|
| **Changes in value of net pension asset/(liability)** | Fair value of plan assets £m | Present value of defined benefit obligations £m | Asset Ceiling (1) £m | Net pension asset £m |
| At 1 January 2018 | 653 | (614) | 0 | 39 |
| Income statement | 17 | (21) | 0 | (4) |
| Statement of comprehensive income | 27 | 18 | (27) | 18 |
| Contributions by employer | 6 | 0 | 0 | 6 |
| Benefits paid | (38) | 38 | 0 | - |
| At 1 January 2019 | 665 | (579) | (27) | 59 |
| Inter group transfer | 121 | (93) | (23) | 5 |
| Income statement: | | | | |
| Interest income | 22 | - | - | 22 |
| Interest expense | - | (19) | (1) | (20) |
| Current service cost | - | (6) | - | (6) |
| Expenses | - | (2) | - | (2) |
| | 22 | (27) | (1) | (6) |
| Statement of comprehensive income: | | | | |
| Actuarial losses due to experience gains | 105 | (2) | - | 103 |
| Actuarial gains due to changes in financial assumptions | - | (116) | - | (116) |
| Actuarial losses due to changes in demographic assumptions | - | 4 | - | 4 |
| Asset ceiling adjustment | - | - | 9 | 9 |
| | 105 | (114) | 9 | - |
| Contributions by employer | 89 | - | - | 89 |
| Benefits paid | (33) | 33 | - | - |
| At 31 December 2019 | 969 | (780) | (42) | 147 |

Note:

(1) The Bank recognises the net pension scheme surplus or deficit as a net asset or liability. In doing so, the funded status is adjusted to reflect any schemes with a surplus that the Bank may not be able to access, as well as any minimum funding requirement to pay in additional contributions.

### 4. Pensions (continued)

| Amounts recognised on the balance sheet | 2019 £m | 2018 £m |
|---|---|---|
| Fund assets at fair value | 969 | 665 |
| Present value of fund liabilities | (780) | (579) |
| Funded status | 189 | 86 |
| Asset ceiling | (42) | (27) |
| | 147 | 59 |

| Net pension asset/(liability) comprises | 2019 £m | 2018 £m |
|---|---|---|
| Net assets of schemes in surplus - IPT | 140 | 59 |
| Net assets of schemes in surplus - UK Scheme | 23 | 27 |
| Net assets of schemes in surplus - IOMB | 26 | - |
| Asset ceiling -UK Scheme | (23) | (27) |
| Asset ceiling - IOMB | (19) | - |
| | 147 | 59 |

#### Funding and contributions by the Company

The Trustees of defined benefit pension schemes are required to perform funding valuations every three years. The Trustees and the Company, with the support of the scheme actuary, agree the assumptions used to value the liabilities and a Schedule of Contributions required to eliminate any funding deficit. The funding assumptions incorporate a margin for prudence over and above the expected cost of providing the benefits promised to members, taking into account the sponsor's covenant and the investment strategy of the scheme.

The Company expects to contribute £10m to its defined benefit pension schemes in 2020.

The weighted average duration of the Company's defined benefit obligation is 23 years (2018: 25years).

#### Critical accounting policy: Pensions

The assets of defined benefit 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 an interest rate based on the yields of high-quality corporate bonds of appropriate duration, with high-quality almost universally understood to mean AA-rated.

The choice of discount rate is a source of estimation uncertainty, due to a lack of appropriate UK-denominated AA-rated bonds of equivalent duration to the pension schemes' liabilities.

The approach used is to fit a yield curve to an appropriate dataset of AA bonds, and derive the discount rate from that curve.

To increase the number of reference bonds available at the end of the reporting period, equivalent AA yields were extrapolated for longer dated A and AAA rated bonds by applying a credit spread adjustment to their actual yields. These were then included in the dataset used to create the yield curve.

#### Assumptions

Placing a value on the Company's defined benefit pension schemes' liabilities requires the Company's management to make a number of assumptions, with the support of independent actuaries who provide advice and guidance. In determining the value of scheme liabilities, financial and demographic assumptions are made as to price inflation, pension increases, earnings growth and employee life expectancy. A range of assumptions could be adopted in valuing the schemes' liabilities. The ultimate cost of the defined benefit obligations to the Company will depend upon actual future events and the assumptions made are unlikely to be exactly borne out in in practice, meaning the final cost may be higher or lower than expected.

A year-end valuation of the Company's pension schemes was prepared to 31 December 2019 by independent actuaries, using the following assumptions for the material pension schemes:

| Principal actuarial assumptions at 31 December | 2019 | 2018 |
|---|---|---|
| Discount rate | 2.05% | 2.90% |
| Rate of increase in salaries | 1.75% | 1.75% |
| Rate of increase in pensions in payment | 2.75% | 2.90% |
| Inflation assumption | 2.90% | 3.15% |

| Post–retirement mortality assumptions | 2019 | 2018 |
|---|---|---|
| Longevity at age 60 for current pensioners aged 60 (years) | | |
| Males | 28.5 | 28.7 |
| Females | 29.7 | 29.9 |
| Longevity at age 60 for future pensioners currently aged 40 (years) | | |
| Males | 30.0 | 30.3 |
| Females | 31.2 | 31.4 |

These post-retirement mortality assumptions are derived from standard mortality tables used by the scheme actuary to value the liabilities for the main scheme.

## 4. Pensions (continued)

### Discount rate

The Sterling yield curve is constructed by reference to yields on 'AA' corporate bonds from which a single discount rate is derived based on a cash flow profile similar in structure and duration to the pension obligations. Significant judgement is required when setting the criteria for bonds to be included in the population from which the yield curve is derived. The criteria include issuance size, quality of pricing and the exclusion of outliers. Judgement is also required in determining the shape of the yield curve at long durations. For the Sterling curve, a constant credit spread relative to gilts is assumed at long durations.

The table below sets out the sensitivities of the pension cost for the year and the present value of defined benefit obligations at the balance sheet dates to a change in the principal actuarial assumptions:

| | (Decrease)/increase in pension cost for the year | | (Decrease)/increase in obligation at 31 December | |
|---|---|---|---|---|
| | 2019 | 2018 | 2019 | 2018 |
| | £m | £m | £m | £m |
| 0.25% increase in the discount rate | (2) | (2) | (42) | (32) |
| 0.25% increase in inflation | 1 | 1 | 33 | 24 |
| 0.25% additional rate of increase in pensions in payment | 1 | 1 | 20 | 14 |
| 0.25% additional rate of increase in deferred pensions | - | - | 13 | 10 |
| 0.25% additional rate of increase in salaries | - | - | 3 | 2 |
| Longevity increase of one year | 1 | 1 | 18 | 18 |

Pension liabilities are calculated on the central assumptions and under the relevant sensitivity scenarios. The sensitivity to pension liabilities is the difference between these calculations.

The sensitivity analysis presented above may not be representative of the actual change in the defined benefit obligation as it is unlikely that the changes in assumptions would occur in isolation of one another as some of the assumptions may be correlated.

The experience history of the Company's schemes is shown below.

| | 2019 | 2018 | 2017 | 2016 | 2015 |
|---|---|---|---|---|---|
| **History of defined benefit schemes** | £m | £m | £m | £m | £m |
| Fair value of plan assets | 969 | 665 | 653 | 653 | 460 |
| Present value of plan obligations | (780) | (579) | (614) | (655) | (498) |
| Fund status | 189 | 86 | 39 | (2) | (38) |
| Asset ceiling | (42) | (27) | - | - | - |
| Net surplus/(deficit) | 147 | 59 | 39 | (2) | (38) |
| | | | | | |
| Experience gains/(losses) on plan liabilities | (2) | 32 | 7 | - | (8) |
| Experience gains/(losses) on plan assets | 105 | (47) | 38 | 109 | (15) |
| Actual return on pension scheme assets | 127 | (30) | 56 | 128 | 2 |

## 5. Taxation

| | 2019 | 2018 |
|---|---|---|
| | £m | £m |
| Current tax: | | |
| Charge for the year | 49 | 34 |
| Over provision in respect of prior years | (8) | - |
| | 41 | 34 |
| | | |
| Deferred tax: | | |
| Charge for the year | 1 | |
| Tax charge for the year | 42 | 34 |

The actual tax charge differs from the expected tax charge computed by applying the standard rate of income tax as follows: Jersey, Guernsey, Isle of Man and Gibraltar 10% (2018: 10%), London 27% (2018: 27%) and Luxembourg 24.94% (2018: 26.01%).

| | 2019 | 2018 |
|---|---|---|
| | £m | £m |
| Expected tax charge | 34 | 27 |
| Non-deductible items | 2 | 3 |
| Non-taxable items | - | 3 |
| Rate differences on current tax | 14 | 1 |
| Adjustments in respect of prior years | (8) | - |
| Actual tax charge | 42 | 34 |

### 5. Taxation (continued)

Deferred tax

| | 2019 £m | 2018 £m |
|---|---|---|
| Deferred tax assets | 7 | - |
| Deferred tax liabilities | (16) | (8) |
| Net deferred tax liabilities | (9) | (8) |

| | Pension £m | Accelerated capital allowances £m | Other £m | Total £m |
|---|---|---|---|---|
| At 1 January 2018 | (1) | (2) | - | (3) |
| Charge to other comprehensive income | (5) | - | - | (5) |
| At 1 January 2019 | (6) | (2) | - | (8) |
| (Charge)/credit to income statement | (8) | - | 7 | (1) |
| (Charge)/credit to other comprehensive income | (1) | - | 1 | - |
| At 31 December 2019 | (15) | (2) | 8 | (9) |

### 6. Derivatives

The Company enters into various derivatives to manage foreign exchange and interest rate risks. Derivatives include swaps, forwards and options. They may be traded over-the-counter (OTC).

Swaps include currency swaps, interest rate swaps and equity and index swaps. A swap is an agreement to exchange cash flows in the future in accordance with a pre-arranged formula. Interest rate swap contracts generally involve exchange of fixed and floating interest payment obligations without the exchange of the underlying principal amounts.

Forwards include forward foreign exchange contracts and forward rate agreements. A forward contract is a contract to buy or sell a specified amount of a physical or financial commodity, at an agreed price, on an agreed future date.

Forward foreign exchange contracts are contracts for the delayed delivery of currency on a specified future date. Forward rate agreements are contracts under which two counterparties agree on the interest to be paid on a notional deposit of a specified maturity at a specific future date; there is no exchange of principal.

Options include OTC currency options, interest rate caps and floors and swap options. They are contracts that give the holder the right but not the obligation to buy or sell a specified amount of the underlying physical or financial commodity at an agreed price on an agreed date or over an agreed period. The CVA adjustment will not have a material impact on fair value.

Included in the table below are derivatives entered into during the normal course of business with customers and RBS Group companies:

| | 2019 | | | 2018 | | |
|---|---|---|---|---|---|---|
| | Notional amounts £m | Assets £m | Liabilities £m | Notional amounts £m | Assets £m | Liabilities £m |
| Exchange rate contracts | | | | | | |
| Spots and forwards - RBS entities | 2,158 | 26 | 17 | 1,979 | 18 | 21 |
| Spots and forwards - third party | 862 | 9 | 14 | 811 | 7 | 3 |
| Interest rate swaps | | | | | | |
| RBS entities | 585 | 1 | 25 | 591 | 1 | 13 |
| | 3,605 | 36 | 56 | 3,381 | 26 | 37 |

The Bank applies hedge accounting to manage interest rate risk.

Bank's interest rate hedging relate to the non-trading structural interest rate risk, caused by the mismatch between fixed interest rates and floating interest rates. The bank manages this risk within approved limits. Residual risk positions are hedged with derivatives principally interest rate swaps.

Fair value hedges of interest rate risk involve interest rate swaps transforming the fixed interest rate risk in recognised financial assets and financial liabilities to floating.

The hedged risk is the risk of changes in the hedged items fair value attributable to changes in the benchmark interest rate embedded in the hedged item. This risk component is identified using the risk management systems of the bank. This risk component comprises the majority of the hedged items fair value risk.

A number of the fair value hedges of interest rate risk will be directly affected by interest rate benchmark reform. As at 31 December 2019 the exact transition dates of affected hedge accounting relationships is not known.

### 6. Derivatives (continued)

Included in the table below are derivatives held for hedging purposes as follows:

| | 2019 | | | 2018 | | |
|---|---|---|---|---|---|---|
| | Notional amounts £m | Assets £m | Liabilities £m | Notional amounts £m | Assets £m | Liabilities £m |
| Fair Value hedging | | | | | | |
| Interest rate contracts | 559 | - | 22 | 545 | - | 10 |

The notional of hedging instruments which have maturity greater than 31 December 2021 affected by interest rate benchmark reform (SONIA not subject to reform) is as follows:

| | 2019 £m |
|---|---|
| Fair Value hedging | |
| - LIBOR | 274 |
| - EURIBOR | 65 |
| | 339 |

Hedge ineffectiveness recognised in other operating income comprised:

| | 2019 £m | 2018 £m |
|---|---|---|
| (Losses)/gains on the hedged items attributable to the hedged risk | (2) | 1 |
| Gains/(losses) on the hedging instruments | 2 | (1) |
| Fair value hedging ineffectiveness | - | - |

### 7. Other financial assets

| 2019 | Equity shares £m | Debt securities [1,2] £m | Total £m |
|---|---|---|---|
| Fair value through other comprehensive income | 1 | 1,759 | 1,760 |
| Amortised cost | - | 3,309 | 3,309 |
| Total | 1 | 5,068 | 5,069 |
| **2018** | | | |
| Fair value through other comprehensive income | 2 | - | 2 |
| Amortised cost | - | 3,729 | 3,729 |
| | 2 | 3,729 | 3,731 |

Notes:
(1) £3,309m (2018: £3,729m) with Central and local government
(2) £1,759m (2018: nil) with US correspondent banks

Other Financial assets at amortised costs are made of debt securities in the following currencies:

| Currency | S&P Risk Rating | Moody's Risk Rating | 2019 £m | 2018 £m |
|---|---|---|---|---|
| GBP | AA | Aa2 | 2,945 | 3,345 |
| EUR | AAA | Aaa | 123 | 120 |
| USD | AA+ | Aa1 | 2,000 | 264 |
| | | | 5,068 | 3,729 |

## 8. Financial instruments - classification

The following tables analyse financial assets and financial liabilities in accordance with the categories of financial instruments in IFRS 9. Assets and liabilities outside the scope of IFRS 9 are shown within other assets and other liabilities.

| 2019 | MFVPL (1) £m | FVOCI (2) £m | Amortised cost £m | Other assets/ liabilities £m | Total £m |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash and balances at central banks | - | - | 10,617 | - | 10,617 |
| Derivatives | 36 | - | - | - | 36 |
| Loans to banks - amortised costs | - | - | 1,337 | - | 1,337 |
| Loans to customers - amortised costs | - | - | 14,115 | - | 14,115 |
| Amounts due from holding companies and fellow subsidiaries | - | - | 1,056 | - | 1,056 |
| Other financial assets | - | 1,760 | 3,309 | - | 5,069 |
| Intangible assets | - | - | - | 7 | 7 |
| Other assets | - | - | - | 247 | 247 |
| | 36 | 1,760 | 30,434 | 254 | 32,484 |
| **Liabilities** | | | | | |
| Banks deposits | - | - | 14 | - | 14 |
| Customer deposits | - | - | 30,137 | - | 30,137 |
| Derivatives | 56 | - | - | - | 56 |
| Amounts due to holding companies and fellow subsidiaries | - | - | 279 | - | 279 |
| Other liabilities | - | - | - | 160 | 160 |
| | 56 | - | 30,430 | 160 | 30,646 |
| Owners' equity | | | | | 1,838 |
| | | | | | 32,484 |

Notes:
(1) Mandatory fair value through profit or loss.
(2) Fair value through other comprehensive income.

| 2018 | MFVPL (1) £m | FVOCI (2) £m | Amortised cost £m | Other assets/ liabilities £m | Total £m |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash and balances at central banks | - | - | 10,437 | - | 10,437 |
| Derivatives | 26 | - | - | - | 26 |
| Loans to banks - amortised costs | - | - | 483 | - | 483 |
| Loans to customers - amortised costs | - | - | 12,621 | - | 12,621 |
| Other loans | 2 | - | - | - | 2 |
| Amounts due from holding companies and fellow subsidiaries | - | - | 3,037 | - | 3,037 |
| Other financial assets | - | 2 | 3,729 | - | 3,731 |
| Intangible assets | - | - | - | 8 | 8 |
| Other assets | - | - | - | 104 | 104 |
| | 28 | 2 | 30,307 | 112 | 30,449 |
| **Liabilities** | | | | | |
| Banks deposits | - | - | 2 | - | 2 |
| Customer deposits | - | - | 25,998 | - | 25,998 |
| Derivatives | 37 | - | - | - | 37 |
| Other financial liabilities | 2 | - | - | - | 2 |
| Amounts due to holding companies and fellow subsidiaries | - | - | 2,282 | - | 2,282 |
| Other liabilities | - | - | - | 107 | 107 |
| | 39 | - | 28,282 | 107 | 28,428 |
| Equity | | | | | 2,021 |
| | | | | | 30,449 |

Notes:
(1) Mandatory fair value through profit or loss.
(2) Fair value through other comprehensive income.

**8. Financial instruments- valuation**

**Critical accounting policy: Fair value - financial instruments**

In accordance with accounting policies 12 and 18, financial instruments classified as mandatory fair value through profit or loss and financial assets classified as fair value through other comprehensive income are recognised in the financial statements at fair value. All derivatives are measured at fair value.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement takes into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. It also uses the assumptions that market participants would use when pricing the asset or liability.

In determining fair value the Bank maximises the use of relevant observable inputs and minimises the use of unobservable inputs.

Where the Bank manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, it measures the fair value of a group of financial assets and financial liabilities on the basis of the price that it would receive to sell a net long position (i.e. an asset) for a particular risk exposure or to transfer a net short position (i.e. a liability) for a particular risk exposure in an orderly transaction at the measurement date under current market conditions.

Credit valuation adjustments are made when valuing derivative financial assets to incorporate counterparty credit risk. Adjustments are also made when valuing financial liabilities measured at fair value to reflect the Bank's own credit standing.

Where the market for a financial instrument is not active, fair value is established using a valuation technique. These valuation techniques involve a degree of estimation, the extent of which depends on the instrument's complexity and the availability of market-based data. Further details about the valuation methodologies and the sensitivity to reasonably possible alternative assumptions of the fair value of financial instruments valued using techniques where at least one significant input is unobservable are given below.

**Valuation of financial instruments carried at fair value**

Fair Value Hierarchy

Financial instruments carried at fair value have been classified under the IFRS fair value hierarchy as follows.

Level 1 – instruments valued using unadjusted quoted prices in active and liquid markets, for identical financial instruments. Examples include government bonds, listed equity shares and certain exchange-traded derivatives.

Level 2 - instruments valued using valuation techniques that have observable inputs. Examples include most government agency securities, investment-grade corporate bonds, certain mortgage products, including collateralised loan obligations (CLO), most bank loans, repos and reverse repos, less liquid listed equities, state and municipal obligations, most notes issued, and certain money market securities and loan commitments and most over-the-counter (OTC) derivatives.

Level 3 - instruments valued using a valuation technique where at least one input, which could have a significant effect on the instrument's valuation, is not based on observable market data. Examples include cash instruments which trade infrequently, certain syndicated and commercial mortgage loans, certain emerging markets and derivatives with unobservable model inputs.

| | 2019 | | | | 2018 | | | |
|---|---|---|---|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total | Level 1 | Level 2 | Level 3 | Total |
| | £m | £m | £m | £m | £m | £m | £m | £m |
| **Assets** | | | | | | | | |
| Derivatives(1) | - | 36 | - | 36 | 24 | 2 | - | 26 |
| Other loans | - | - | - | - | - | 2 | - | 2 |
| Other financial assets | | | | | | | | |
| Securities | 1,759 | 1 | - | 1,760 | - | 2 | - | 2 |
| **Total financial assets at fair value** | 1,759 | 37 | - | 1,796 | 24 | 6 | - | 30 |
| **Liabilities** | | | | | | | | |
| Derivatives(1) | - | 56 | - | 56 | 24 | 13 | - | 37 |
| Other financial Liabilities | | | | | | | | |
| Deposits | - | - | - | - | - | 2 | - | 2 |
| **Total financial liabilities at fair value** | - | 56 | - | 56 | 24 | 15 | - | 39 |

Note:

(1) In prior year, foreign exchange forward contracts were classified as level 1 while interest rate swaps were classified as level 2. In 2019, all derivatives are classified as level 2 as the derivatives are valued using valuation techniques that have observable inputs.

**8. Financial instruments- valuation (continued)**

Inputs to valuation models

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

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

Fair value of Financial Instruments not carried at fair value

The following table shows the carrying values and the fair values of financial instruments on the balance sheet carried at amortised cost: all assets and liabilities carried at amortised cost on the balance sheet fall within level 3 of the valuation methodologies.

| | 2019 Carrying value £m | 2019 Fair value £m | 2018 Carrying value £m | 2018 Fair value £m |
|---|---|---|---|---|
| **Financial assets** | | | | |
| Cash and balances at central banks | 10,617 | 10,617 | 10,437 | 10,437 |
| Loans to banks - amortised costs | 1,337 | 1,337 | 483 | 483 |
| Loans to customers - amortised costs | 14,115 | 14,212 | 12,621 | 12,469 |
| Amounts due from holding companies and fellow subsidiaries | 1,056 | 1,056 | 3,037 | 3,037 |
| Other financial assets | 3,309 | 3,345 | 3,729 | 3,729 |
| **Financial liabilities** | | | | |
| Bank deposits | 14 | 14 | 2 | 2 |
| Customer deposits | 30,137 | 30,137 | 25,998 | 25,998 |
| Amounts due to holding companies and fellow subsidiaries | 279 | 279 | 2,282 | 2,282 |

Differences between the carrying value and the fair value of loans and receivables to customers above relate specifically to certain advances that are at fixed interest rates and fixed maturity dates. There is no intention to break any of these advances prior to maturity and the difference between carrying value and fair value is never expected to be realised.

The fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Quoted market values are used where available; otherwise, fair values have been estimated based on discounted expected future cash flows and other valuation techniques. These techniques involve uncertainties and require assumptions and 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 or settlement. As a wide range of valuation techniques are available, it may be inappropriate to compare the Company’s fair value information to independent markets or other financial institutions’ fair values.

The assumptions and methodologies underlying the calculation of fair values of financial instruments at the balance sheet date are set out below:

Short term financial instruments

The fair value of financial instruments that are of short maturity (3 months or less) approximate their carrying value.

This applies mainly to cash and balances at central banks, items in the course of collection from other banks, settlement balances, items in the course of transmission to other banks and demand deposits.

Loans to banks and customers

In estimating the Fair value of loans and advances to banks and customers measured at amortised cost, loans are segregated into appropriate portfolios estimated by grouping loans into homogeneous portfolios reflecting the characteristics of the constituent loans and applying a discount rate to the cash flows. The discount rate is based on the market rate applicable at the balance sheet date for a similar portfolio with similar maturity and credit risk characteristics.

Two principal methods are used to estimate fair value:

(a) Contractual cash flows are discounted using a market discount rate that incorporates the current spread for the borrower or where that is not observable, the spread for borrowers of a similar credit standing.

(b) Expected cash flows (unadjusted for credit losses) are discounted at the current offer rate for the same or similar products.

Debt securities

The majority of debt securities are valued using quoted prices in active markets, or using quoted prices for similar assets in active markets. Fair values of the rest are determined using discounted cash flow valuation techniques.

Deposits by banks and customer accounts

The fair values of deposits are estimated using discounted cash flow valuation techniques.

## 8. Financial instruments- maturity analysis

### Remaining maturity

The following table shows the residual maturity of financial instruments, based on contractual date of maturity.

| | 2019 | | | 2018 | | |
|---|---|---|---|---|---|---|
| | Less than 12 months £m | More than 12 months £m | Total £m | Less than 12 months £m | More than 12 months £m | Total £m |
| **Assets** | | | | | | |
| Cash and balances at central banks | 10,617 | - | 10,617 | 10,437 | - | 10,437 |
| Derivatives | 29 | 7 | 36 | 17 | 9 | 26 |
| Loans to banks - amortised costs | 1,337 | - | 1,337 | 483 | - | 483 |
| Loans to customers - amortised costs | 6,025 | 8,090 | 14,115 | 5,676 | 6,945 | 12,621 |
| Other loans | - | - | - | - | 2 | 2 |
| Amounts due from holding companies and fellow subsidiaries | 1,056 | - | 1,056 | 2,943 | 94 | 3,037 |
| Other financial assets | 1,817 | 3,252 | 5,069 | 921 | 2,810 | 3,731 |
| **Liabilities** | | | | | | |
| Banks deposits | 14 | - | 14 | 2 | - | 2 |
| Customer deposits | 30,131 | 6 | 30,137 | 25,998 | - | 25,998 |
| Derivatives | 27 | 29 | 56 | 22 | 15 | 37 |
| Other financial liabilities | - | - | - | - | 2 | 2 |
| Amounts due to holding companies and fellow subsidiaries | 279 | - | 279 | 2,282 | - | 2,282 |

### On balance sheet assets/liabilities

The tables below show the contractual undiscounted cash flows receivable and payable, up to a period of 20 years, including future receipts and payments of interest of financial assets and liabilities by contractual maturity. The balances in the following tables do not agree directly with the consolidated balance sheet, as the tables include all cash flows relating to principal and future coupon payments, presented on an undiscounted basis.

| 2019 | 0–3 months £m | 3–12 months £m | 1–3 years £m | 3–5 years £m | 5–10 years £m | 10–20 years £m | >20 years £m |
|---|---|---|---|---|---|---|---|
| **Assets by contractual maturity** | | | | | | | |
| Cash and balances at central banks | 10,617 | - | - | - | - | - | - |
| Derivatives | 21 | 8 | 6 | 1 | - | - | - |
| Loans to banks - amortised costs | 1,337 | - | - | - | - | - | - |
| Loans to customers - amortised costs | 2,440 | 3,781 | 4,231 | 1,404 | 874 | 1,412 | 996 |
| Amounts due from holding companies and fellow subsidiaries | 933 | 123 | - | - | - | - | - |
| Other financial assets | 1,413 | 480 | 1,534 | 850 | 1,043 | - | - |
| **Liabilities by contractual maturity** | | | | | | | |
| Bank deposits | 14 | - | - | - | - | - | - |
| Customer deposits | 29,035 | 1,102 | 6 | - | - | - | - |
| Derivatives | 17 | 10 | 8 | 3 | 5 | 9 | 4 |
| Other financial liabilities | - | - | - | - | - | - | - |
| Amounts due to holding companies and fellow subsidiaries | 260 | 19 | - | - | - | - | - |
| **Guarantees and commitments notional amount** | | | | | | | |
| Guarantees(1) | 196 | - | - | - | - | - | - |
| Commitments(2) | 6,391 | - | - | - | - | - | - |

Notes:
(1) The Bank is only called upon to satisfy a guarantee when the guaranteed party fails to meet its obligations. The Bank expects most guarantees it provides to expire unused.
(2) The Bank has given commitments to provide funds to customers under undrawn formal facilities, credit lines and other commitments to lend subject to certain conditions being met by the counterparty. The Bank does not expect all facilities to be drawn, and some may lapse before drawdown.

**8. Financial instruments- maturity analysis (continued)**

| 2018 | 0–3 months £m | 3–12 months £m | 1–3 years £m | 3–5 years £m | 5–10 years £m | 10–20 years £m | >20 years £m |
|---|---|---|---|---|---|---|---|
| **Assets by contractual maturity** | | | | | | | |
| Cash and balances at central banks | 10,437 | - | - | - | - | - | - |
| Derivatives | 8 | 9 | 8 | 1 | - | - | - |
| Loans to banks - amortised costs | 483 | - | - | - | - | - | - |
| Loans to customers - amortised costs | 2,554 | 3,300 | 3,371 | 1,566 | 713 | 1,192 | 794 |
| Other loans | - | - | 2 | - | - | - | - |
| Amounts due from holding companies and fellow subsidiaries | 2,908 | 35 | 94 | - | - | - | - |
| Other financial assets | 64 | 927 | 960 | 1,230 | 803 | - | - |
| **Liabilities by contractual maturity** | | | | | | | |
| Bank deposits | 2 | - | - | - | - | - | - |
| Customer deposits | 25,465 | 537 | 1 | - | - | - | - |
| Derivatives | 13 | 9 | 7 | 2 | - | 6 | - |
| Other financial liabilities | - | - | 2 | - | - | - | - |
| Amounts due to holding companies and fellow subsidiaries | 1,850 | 432 | - | - | - | - | - |
| **Guarantees and commitments notional amount** | | | | | | | |
| Guarantees(1) | 418 | - | - | - | - | - | - |
| Commitments(2) | 14,664 | - | - | - | - | - | - |

Notes:
(1) The Bank is only called upon to satisfy a guarantee when the guaranteed party fails to meet its obligations. The Bank expects most guarantees it provides to expire unused.
(2) The Bank has given commitments to provide funds to customers under undrawn formal facilities, credit lines and other commitments to lend subject to certain conditions being met by the counterparty. The Bank does not expect all facilities to be drawn, and some may lapse before drawdown.

The tables above show the timing of cash outflows to settle financial liabilities, prepared on the following basis:

Financial liabilities are included at the earliest date on which the counterparty can require repayment regardless of whether or not such early repayment results in a penalty. If repayment is triggered by, or is subject to, specific criteria such as market price hurdles being reached, the liability is included at the earliest possible date that the conditions could be fulfilled without considering the probability of the conditions being met. For example, if a structured note automatically prepays when an equity index exceeds a certain level, the cash outflow will be included in the less than three months' period whatever the level of the index at the year end.

The Bank's financial assets and liabilities include:

| | 2019 £m | 2018 £m |
|---|---|---|
| Reverse repos | | |
| Loans to banks - amortised costs | 650 | - |
| Repo | | |
| Bank deposits | (650) | - |
| Loans to customers - amortized costs | | |
| Central and local government | 68 | - |
| Service industries and business activities | 6 | 9 |
| Customer deposits | | |
| Central and local government | (68) | - |
| Service industries and business activities | (6) | (9) |

The above financial instruments are subject to IAS 32 (on balance sheet) netting arrangements or subject to enforceable master netting instruments and gives right to set off the financial asset against a financial liability due to same counterparty.

## 9. Loan impairment provisions

| | 31 December 2019 £m | 31 December 2018* £m |
|---|---|---|
| Loans | | |
| Stage 1 | 14,815 | 12,754 |
| Stage 2 | 545 | 262 |
| Stage 3 | 121 | 94 |
| Inter- group (1) | 1,056 | 3,037 |
| Total | 16,537 | 16,147 |
| Loans impairment provisions | | |
| ECL provisions | | |
| Stage 1 | 3 | 6 |
| Stage 2 | 6 | 3 |
| Stage 3 | 21 | 23 |
| Total | 30 | 32 |
| ECL provision coverage (2,3) | | |
| Stage 1 (%) | 0.02 | 0.05 |
| Stage 2 (%) | 1.10 | 1.15 |
| Stage 3 (%) | 17.36 | 24.47 |
| | 0.19 | 0.24 |
| Impairment losses/(releases) | | |
| ECL charge | | |
| Third party | 2 | - |
| Inter- group | - | (1) |
| Total | 2 | (1) |
| ECL loss rate - annualised (basis points) | 1.29 | - |
| Amounts written off | 5 | 8 |

*2018 data has been restated for a change to presentation of unrecognised interest. Refer to Accounting policy 1, Other amendments to IFRS, for further details.

Notes:
(1) Amounts due from holding companies and fellow subsidiaries (Inter-Group) are all considered as Stage 1.
(2) ECL provisions coverage is ECL provisions divided by loans - amortised cost.
(3) ECL provisions coverage and ECL loss rates are calculated on third party loans and related ECL provisions and charge respectively.

### Critical accounting estimates

The loan impairment provisions have been established in accordance with IFRS 9. Accounting policy 13 sets out how the expected loss approach is applied. At 31 December 2019, customer loan impairment provisions amounted to £30m (2018 Restated: £32m). A loan is impaired when there is objective evidence that the cash flows will not occur in the manner expected when the loan was advanced. Such evidence includes changes in the credit rating of a borrower, the failure to make payments in accordance with the loan agreement; significant reduction in the value of any security; breach of limits or covenants; and observable data about relevant macroeconomic measures.

The impairment loss is the present value of the difference between the contractual cash flows that are due under the contract and the cash flows the entity expects to receive.

IFRS 9 ECL model design principles
To meet IFRS 9 requirements for ECL estimation, Probability of default (PD), Loss given default (LGD) and Exposure at default (EAD) used in the calculations must be:

- Unbiased - material regulatory conservatism has been removed to produce unbiased model estimates;
- Point-in-time - recognise current economic conditions;
- Forward-looking - incorporated into PD estimates and, where appropriate, EAD and LGD estimates; and
- For the life of the loan - all models produce a term structure to allow a lifetime calculation for assets in Stage 2 and Stage 3.

IFRS 9 requires that at each reporting date, an entity shall assess whether the credit risk on an account has increased significantly since initial recognition. Part of this assessment requires a comparison to be made between the current lifetime PD (i.e. the current probability of default over the remaining lifetime) with the equivalent lifetime PD as determined at the date of initial recognition.

The general approach for the IFRS 9 LGD models has been to leverage the Basel LGD models with bespoke IFRS 9 adjustments to ensure unbiased estimates, i.e. use of effective interest rate as the discount rate and the removal of: downturn calibration, indirect costs, other conservatism and regulatory floors.

For Wholesale, while conversion ratios in the historical data show temporal variations, these cannot (unlike in the case of PD and some LGD models) be sufficiently explained by the Credit-Cycle Index ('CCI') measure and are presumed to be driven to a larger extent by exposure management practices. Therefore point-in-time best estimates measures for EAD are derived by estimating the regulatory model specification on a rolling five year window.

Approach for multiple economic scenarios (MES)
The base scenario plays a greater part in the calculation of ECL than the approach to MES. This is discussed further in Note17.

## 10. Property, plant and equipment

| 2019 | Freehold premises £m | Long leasehold premises £m | Computers and other equipment £m | Right of use property £m | Total £m |
|---|---|---|---|---|---|
| Cost or valuation | | | | | |
| At 1 January | 22 | 3 | 93 | - | 118 |
| Implementation of IFRS 16 on 1 January 2019 (1) | - | - | - | 90 | 90 |
| Transfers | 5 | - | 3 | - | 8 |
| Other adjustments (2) | - | - | - | (35) | (35) |
| Additions (3) | 1 | - | 11 | 15 | 27 |
| Disposals | - | (1) | (7) | - | (8) |
| At 31 December | 28 | 2 | 100 | 70 | 200 |
| | | | | | |
| Accumulated depreciation and amortisation: | | | | | |
| At 1 January | 4 | 2 | 75 | - | 81 |
| Implementation of IFRS 16 on 1 January 2019 (1) | - | - | - | 46 | 46 |
| Transfers | 1 | - | 3 | - | 4 |
| Other adjustments (2) | - | - | - | (20) | (20) |
| Disposals | - | - | (6) | - | (6) |
| Depreciation charge for the year | - | - | 5 | 5 | 10 |
| At 31 December | 5 | 2 | 77 | 31 | 115 |
| | | | | | |
| Net book value at 31 December 2019 | 23 | - | 23 | 39 | 85 |

| 2018 | Freehold premises £m | Long leasehold premises £m | Computers and other equipment £m | Right of use property £m | Total £m |
|---|---|---|---|---|---|
| Cost or valuation | | | | | |
| At 1 January | 21 | 3 | 84 | - | 108 |
| Additions | 2 | - | 10 | - | 12 |
| Disposals | (1) | - | (1) | - | (2) |
| At 31 December | 22 | 3 | 93 | - | 118 |
| | | | | | |
| Accumulated depreciation and amortisation: | | | | | |
| At 1 January | 3 | 2 | 71 | - | 76 |
| Depreciation charge for the year | 1 | - | 4 | - | 5 |
| At 31 December | 4 | 2 | 75 | - | 81 |
| | | | | | |
| Net book value at 31 December 2018 | 18 | 1 | 18 | - | 37 |

Note:
(1) Includes amount transferred from IOMB for plant and equipment of £19m and depreciation of £12m.
(2) Other adjustments relate to the surrender of the headlease for a property in Guernsey.
(3) Additions to fixed assets include £5m of capital work in progress which represents costs incurred on fixed assets which are under development at the balance sheet date.

## 11. Intangible assets

| 2019 | Software development £m | Goodwill (1) £m | Total £m |
|---|---|---|---|
| Cost: | | | |
| At 1 January and 31 December | 5 | 6 | 11 |
| | | | |
| Amortisation: | | | |
| At 1 January | 3 | - | 3 |
| Charge for the year | 1 | - | 1 |
| At 31 December | 4 | - | 4 |
| | | | |
| Net book value at 31 December 2019 | 1 | 6 | 7 |

### 11. Intangible assets (continued)

| 2018 | Software development £m | Goodwill [1] £m | Total £m |
|---|---|---|---|
| Cost: | | | |
| At 1 January and 31 December | 5 | 6 | 11 |
| | | | |
| Amortisation: | | | |
| At 1 January | 2 | - | 2 |
| Charge for the year | 1 | - | 1 |
| At 31 December | 3 | - | 3 |
| | | | |
| Net book value at 31 December 2018 | 2 | 6 | 8 |

The amortisation cost for the year was £892k (2018: £910k). The amortisation period for software development costs is 5 years. The amortisation is calculated using the straight line method.

Note:
(1) Intangible assets created through acquisition. Refer accounting policy 5.

### 12. Other assets

| | 2019 £m | 2018 £m |
|---|---|---|
| Property plant and equipment (refer Note 10) | 85 | 37 |
| Prepayments, accrued income and other assets | 8 | 8 |
| Deferred Tax (refer Note 5) | 7 | - |
| Retirement benefit assets (refer Note 4) | 147 | 59 |
| | 247 | 104 |

### 13. Other liabilities

| | 2019 £m | 2018 £m |
|---|---|---|
| Accruals and deferred income | 64 | 66 |
| Provisions for liabilities and charges | 10 | 12 |
| Current tax | 23 | 19 |
| Deferred tax (refer Note 5) | 16 | 8 |
| Other liabilities | 4 | 2 |
| Lease liabilities (refer Note 16) | 43 | - |
| | 160 | 107 |

The following amounts are included within provisions:

| | Property [1] £m | Restructuring [2] £m | Customer redress [3] £m | Litigation and other regulatory [4] £m | Other £m | Total £m |
|---|---|---|---|---|---|---|
| At 1 January 2018 | 4 | 5 | 2 | 8 | - | 19 |
| Implementation of IFRS 9 on 1 January 2018 | - | - | - | - | 2 | 2 |
| Charged to the income statement | - | 4 | 1 | - | - | 5 |
| Released during the year | (1) | - | (1) | (8) | - | (10) |
| Utilised in year | - | (4) | - | - | - | (4) |
| At 1 January 2019 | 3 | 5 | 2 | - | 2 | 12 |
| Transfer from IOMB | - | 1 | 1 | - | - | 2 |
| Charged to the income statement | 1 | 5 | - | - | - | 6 |
| Released during the year | - | (1) | - | - | (1) | (2) |
| Utilised in year | (3) | (5) | - | - | - | (8) |
| At 31 December 2019 | 1 | 5 | 3 | - | 1 | 10 |

(1) **Property provision**
The property provisions principally comprise of onerous lease provision and dilapidation cost.

(2) **Restructuring provision**
The Company has reviewed its organisational design and how it is managed to ensure it has the most effective and efficient cost base. To this end £5m has been charged in the year.

### 13. Other liabilities (continued)

(3) **Customer redress provision**
The Company has provided for customer redress in relation to payment protection insurance and other Personal products.

(4) **Litigation and other regulatory**
The Company is party to certain legal proceedings and regulatory investigations and continues to co-operate with a number of regulators. All such matters are periodically reassessed with the assistance of external professional advisers, where appropriate, to determine the likelihood of the Company incurring a liability and to evaluate the extent to which a reliable estimate of any liability can be made.

**Critical accounting policy: Provisions for liabilities and charges**

Judgment is involved in determining whether an obligation exists, and in estimating the probability, timing and amount of any outflows. The Board does not believe there is a significant risk of a material adjustment as a result of possible changes in these estimates. Where the Company can look to another party such as an insurer to pay some or all of the expenditure required to settle a provision, any reimbursement is recognised when, and only when, it is virtually certain that it will be received.

**Estimates** - Provisions are liabilities of uncertain timing or amount, and are recognised when there is a present obligation as a result of a past event, the outflow of economic benefit is probable and the outflow can be estimated reliably.

### 14. Called up share capital

| | Allotted, called up and fully paid | | Authorised | |
|---|---|---|---|---|
| | 31 December 2019 £m | 31 December 2018 £m | 2019 £m | 2018 £m |
| *Equity shares:* | | | | |
| Ordinary shares of £1 | 97 | 97 | 300 | 300 |
| Total share capital | 97 | 97 | 300 | 300 |

The whole of the issued share capital of the Company comprises one class of Ordinary Share held by its holding company, The Royal Bank of Scotland International (Holdings) Limited and its nominee, each share being entitled to one vote.

### 15. Paid-in equity

Paid-in equity comprises equity instruments issued by the Bank to RBS Group, other than those legally constituted as shares.

| | 31 December 2019 £m | 31 December 2018 £m |
|---|---|---|
| *Additional Tier 1 capital notes:* | | |
| £300m 6.604% notes repayable from September 2025 | 300 | - |
| | 300 | - |

The coupons on this instrument are non-cumulative and payable at the Company's discretion. In the event of winding up, any amounts outstanding on the loan will be subordinated. While taking the legal form of debt these notes are classified as equity under IFRS.

### 16. Leases

The Company has adopted IFRS 16 Leases from 1 January 2019, but has not restated comparatives as permitted under the transition provisions of the standard.

The impact (increase/(decrease)) to the balance sheet at 1 January 2019 is as follows:

| | £m |
|---|---|
| Retained earnings at 1 January 2019 prior to IFRS 16 | 1,919 |
| Other assets - Net right of use assets | 36 |
| - Recognition of lease liabilities | (40) |
| - Provision for onerous leases | - |
| Other liabilities | (40) |
| Net impact on retained earnings | (4) |
| Adjusted Retained earnings at 1 January 2019 | 1,915 |

On adoption of IFRS 16, RBSI recognised right of use assets and lease liabilities in relation to leases which has been previously classified as operating leases under IAS17 Leases subject to certain practical expedites as allowed by the standard (see below).

The following practical expedients permitted by the standard were used:
- A single rate discount rate has been applied to a portfolio of lease with reasonably similar characteristics.
- Applied the accounting exemption for operating leases with a remaining lease term of 12 months at 1 January 2019 for non property leases.
- Exclusion of initial direct costs from the measurement of the right of use asset at the date of initial application.
- The use of hindsight where contracts contain options to extend or terminate the lease in determining the lease term.

### 16. Leases (continued)

The lease liabilities were measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate as of 1 January 2019. The weighted average lessee's incremental borrowing rate applied to the lease liabilities on 1 January 2019 was 2.10%.

| | 2019<br>£m |
|---|---|
| Operating lease commitments as disclosed at 31 December 2018 | 48 |
| Discounted using the incremental borrowing rate | (8) |
| Lease liability recognised as at 1 January 2019 on adoption of IFRS 16 | 40 |

**Lessee**

| | 2019<br>£m |
|---|---|
| Amounts recognised in income statement | |
| Interest payable | 1 |
| Depreciation on Right of use assets | 5 |
| Rental expense on short leases | 1 |
| Losses from sale and lease back transactions | (2) |

Rental expense in respect of operating leases in 2018 was £5m.

| | 2019<br>£m |
|---|---|
| Amounts recognised on Balance Sheet | |
| Right of use assets included in property, plant and equipment(1) | 39 |
| Additions to right of use assets | 15 |
| Lease Liabilities | (43) |

Note:
(1) Includes right of use asset for plant and equipment of £70m and depreciation of £31m.

| | 2018<br>£m |
|---|---|
| Operating Leases - Premises | |
| Minimum rentals payable under non-cancellable leases | |
| - within 1 year | 4 |
| - after 1 year but within 5 years | 15 |
| - after 5 years | 29 |
| Total | 48 |

**Lessor**

Acting as a lessor, the bank provides asset finance to its customers. It purchases plant, equipment and intellectual property, renting them to customers under lease arrangements that, depending on their terms, qualify as either operating or finance leases. The management of the risk that customers fail to meet their contractual obligation to settle outstanding amounts under finance leases is covered in the credit risk section in note 17.

| Amounts included in income statement | 2019<br>£m |
|---|---|
| Finance leases | |
| Finance income on the net investment in leases | (5) |

| Amount receivable under finance leases | 2019<br>£m |
|---|---|
| Within 1 year | 11 |
| 1 to 2 years | 18 |
| 2 to 3 years | 11 |
| 3 to 4 years | 19 |
| 4 to 5 years | 6 |
| After 5 years | 41 |
| Lease payments total | 106 |
| Unearned income | (28) |
| Present value of lease payments | 78 |
| Impairments | - |
| Net investment in finance leases | 78 |

### 16. Leases (continued)

Minimum amounts receivable under non-cancellable leases:

| | 2018 | | |
|---|---|---|---|
| | Finance lease contracts & hire purchase agreement | | |
| | Gross amounts | Present value adjustments | Present value |
| | £m | £m | £m |
| Within 1 year | 7 | - | 7 |
| 1 to 5 years | 44 | (7) | 37 |
| After 5 years | 29 | (15) | 14 |
| Total | 80 | (22) | 58 |

### 17. Risk management

**Presentation of information**
Risk management is generally conducted on an overall basis within RBS Group such that common policies, procedures, frameworks and models apply across RBS Group, therefore, where appropriate, further detail on risk management practices and methodologies may be found in the RBS Group Annual Report and Accounts.

**Risk management framework**
RBS Group operates an integrated risk management framework, which is centred around the embedding of a strong risk culture. The framework ensures the tools and capability are in place to facilitate risk management and decision-making across the organisation.

Risk appetite, supported by a robust set of principles, policies and practices, defines the levels of tolerance for a variety of risks and provides a structured approach to risk-taking within agreed boundaries.

All RBS Group colleagues share ownership of the way risk is managed, working together to make sure business activities and policies are consistent with risk appetite.

The methodology for setting, governing and embedding risk appetite is being further enhanced with the aim of revising current risk appetite processes and increasing alignment with strategic planning and external threat assessments.

During 2019, a number of enhancements to the RBS Group risk management framework were developed. The increasing significance of climate risk was considered as part of these developments and will be fully integrated as part of the implementation of the enhanced framework in 2020.

**Risk culture**
Risk culture is at the centre of both the risk management framework and risk management practice. The target culture across the Company is one in which risk is part of the way employees work and think. The target risk culture behaviours are aligned to the Company's core values. They are embedded in Our Standards and therefore form an effective basis for risk culture since these are used for performance management, recruitment and development. For further information on risk culture, refer RBS Group Annual Report and Accounts.

Training
A wide range of learning, both technical and behavioural, is offered across the risk disciplines. This training can be mandatory, role-specific or for personal development and enables colleagues to develop the capabilities and confidence to manage risk effectively.

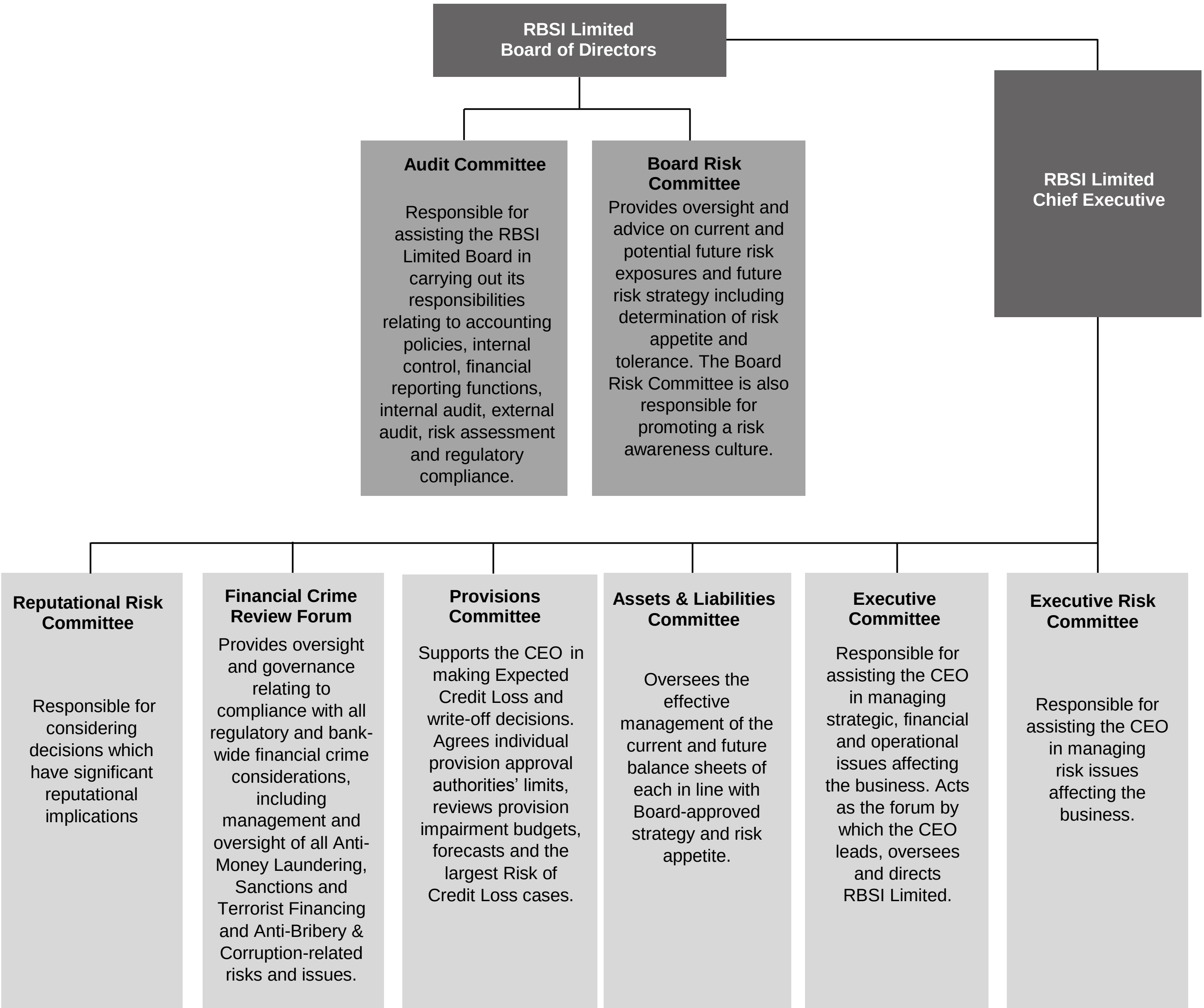
Code of Conduct
A Code of Conduct is in place across all entities within RBS Group. It provides guidance on the behaviour expected of employees and describes the principles that must be followed. For more information, refer RBS Group Annual Report and Accounts.

### 17. Risk management (continued)

**Risk governance**

Committee structure

The diagram illustrates the Company's risk committee structure in 2019 and the main purposes of each committee.



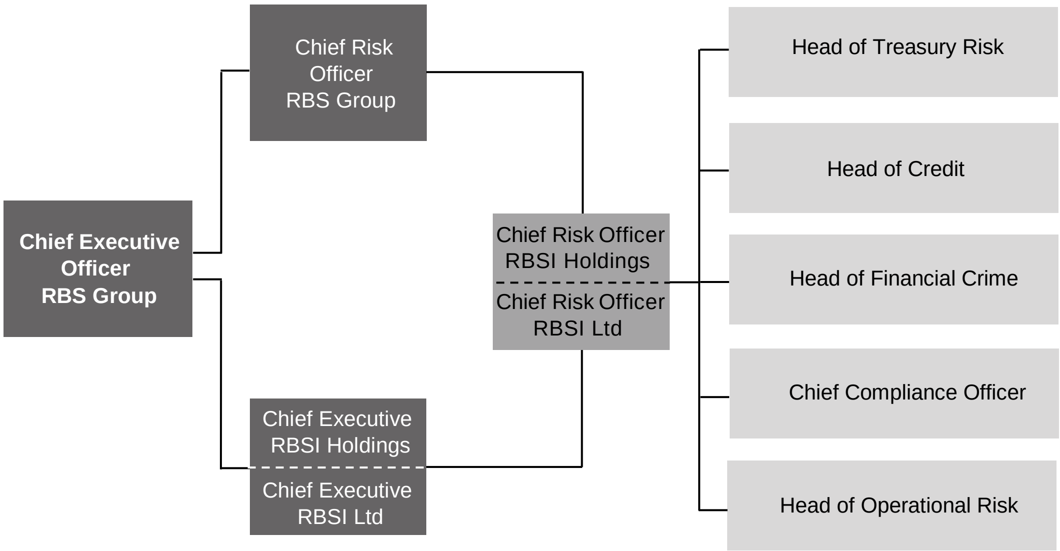

Notes:

(1) The Royal Bank of Scotland International Limited is one of the principal operating subsidiaries of RBSI (Holdings) Limited.
(2) The chart above does not show all management-level committees, only material committees which consider risk are shown.
(3) The NatWest Holdings Group Risk function provides risk management services across the RBS Group, including – where agreed – to the RBSI Limited Chief Risk Officer. These services are managed, as appropriate, through service level agreements.

## 17. Risk management (continued)

### Risk management structure

The diagram illustrates the Company's risk management structure in 2019 and key risk management responsibilities.




Notes:
(1) RBSI Limited is a wholly owned subsidiary of RBSI (Holdings) Limited.
(2) The RBSI Limited Chief Risk Officer reports directly to i) the RBSI Limited Chief Executive Officer, who is also the RBSI (Holdings) Limited CEO and ii) the RBS Group Chief Risk Officer. There is an additional reporting line to the chair of the RBSI Limited Board Risk Committee, and a right of access to the committee.

### Three lines of defence

The three lines of defence model is used across the bank to articulate accountabilities and responsibilities for managing risk. The first line is accountable for managing its own risks within the appetite set by the Board. It incorporates most roles in the bank, including those in the customer-facing businesses, Technology and Services as well as support functions such as Human Resources, Legal and Finance.

The second line of defence is the Risk function which is responsible for the design and maintenance of the risk management framework as well as advising, monitoring, approving, challenging and reporting on the first line's risk-taking activities.

The third line of defence is Internal Audit, which provides assurance to the RBSI Audit Committee on the appropriateness of the design and operational effectiveness of governance, risk management and internal controls to monitor and mitigate material risks. All roles in the Company sit within one of these three lines.

### Risk appetite

Risk appetite defines the level and types of risk that are acceptable, within risk capacity, in order to achieve strategic objectives and business plans. It links the goals and priorities to risk management in a way that guides and empowers staff to serve customers well and achieve financial targets.

The risk appetite framework which is approved annually by the Board bolsters effective risk management by promoting sound risk-taking through a structured approach, within agreed boundaries. It also ensures emerging risks and risk-taking activities that would be out of appetite are identified, assessed, escalated and addressed in a timely manner.

Risk appetite is communicated across the RBS Group through risk appetite statements. These provide clarity on the scale and type of activities that can be undertaken in a manner that is easily conveyed to staff.

The annual process of establishing risk appetite statements is completed alongside the business and financial planning process. This ensures plans and risk appetite are appropriately aligned. The Board sets risk appetite for the most material risks to help ensure the Company is well placed to meet its priorities and long-term targets even under challenging economic environments. It is the basis on which the Company remains safe and sound while implementing its strategic business objectives.

The Company's risk profile is frequently reviewed and monitored and management focus is concentrated on all strategic risks, material risks and emerging risk issues. Risk profile relative to risk appetite is reported regularly to the Board and senior management.

### Risk controls and limits

Risk controls and their associated limits are an integral part of the risk appetite approach and a key part of embedding risk appetite in day-to-day risk management decisions. A clear tolerance for material risk types is set in alignment with business activities.

RBS Group policies support the qualitative aspects of risk appetite. They ensure that appropriate controls are set and monitored.

### Risk identification and measurement

Risk identification and measurement within the risk management process comprise:

- Regular assessment of the overall risk profile, incorporating market developments and trends, as well as external and internal factors.
- Monitoring of the risks associated with lending and credit exposures.
- Assessment of non-traded portfolios.
- Review of potential risks in new business activities and processes.
- Analysis of potential risks in any complex and unusual business transactions.

### 17. Risk management (continued)

The financial and non-financial risks that the Company faces are detailed in the Risk Directory. This provides a common risk language to ensure consistent terminology is used across RBS Group. The Risk Directory is subject to annual review. This ensures that it continues to provide a comprehensive and meaningful list of the inherent risks within the businesses.

Within the Company, a ‘Risk Universe’ is produced to provide a legal entity view of the RBS Group Risk Directory. This helps to acknowledge that there are some risks faced by the Company that are not material at RBS Group level and, conversely, there are risks that are more material to the RBS Group than to the Company directly.

#### Risk treatment and mitigation

Risk treatment and mitigation is an important aspect of ensuring that risk profile remains within risk appetite. Risk mitigation strategies are discussed and agreed with the businesses.

When evaluating possible strategies, costs and benefits, residual risks (risks that are retained) and secondary risks (those that are due to risk mitigation actions) are considered. Monitoring and review processes are in place to evaluate results. Early identification, and effective management, of changes in legislation and regulation are critical to the successful mitigation of compliance and conduct risk. The effects of all changes are managed to ensure the timely achievement of compliance. Those changes assessed as having a high or medium-high impact are managed more closely. Significant and emerging risks that could affect future results and performance are reviewed and monitored. Action is taken to mitigate potential risks as and when required. Further in-depth analysis, including the stress testing of exposures relative to the risk, is also carried out.

#### Risk testing and monitoring

Targeted credit risk, compliance & conduct risk and financial crime risk activities are subject to testing and monitoring to confirm to both internal and external stakeholders – including the Board, senior management, the customer-facing businesses, Internal Audit and the Company’s regulators – that risk owned policies and procedures are being correctly implemented and operating adequately and effectively. Selected key controls are also reviewed. Thematic reviews and deep dives are also carried out where appropriate.

The adequacy and effectiveness of selected key controls owned and operated by the second line of defence are also tested (with a particular focus on credit risk controls). Selected controls within the scope of Section 404 of the US Sarbanes-Oxley Act 2002 as well as selected controls supporting risk data aggregation and reporting are also reviewed.

Anti-money laundering, sanctions, anti-bribery and corruption and tax evasion processes and controls are also tested and monitored. This helps provide an independent understanding of the financial crime control environment, whether or not controls are adequate and effective and whether financial crime risk is appropriately identified, managed and mitigated.

#### Stress testing

##### Stress testing – capital management

Stress testing is a key risk management tool and a fundamental component of the Company’s approach to capital management. It is used to quantify and evaluate the potential impact of specified changes to risk factors on the financial strength of the Company, including its capital position.

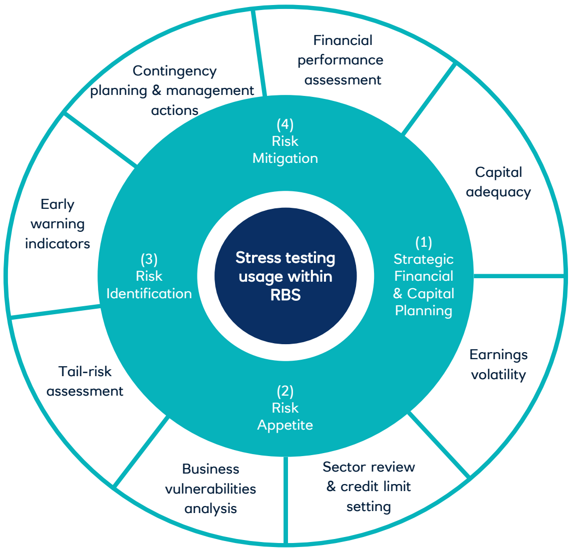
Stress testing includes:

- Scenario testing, which examines the impact of a hypothetical future state to define changes in risk factors.
- Sensitivity testing, which examines the impact of an incremental change to one or more risk factors.

The process for stress testing consists of four broad stages:

| | |
|---|---|
| Define scenarios | • Identify idiosyncratic Company vulnerabilities and risks.<br>• Define and calibrate scenarios to examine vulnerabilities and risks.<br>• Formal governance process to agree scenarios. |
| Assess impact | • Translate scenarios into risk drivers.<br>• Assess impact to current and projected P&L and balance sheet.<br>• Impact assessment captures input from across the Company. |
| Calculate results and assess implications | • Aggregate impacts into overall results.<br>• Results form part of risk management process.<br>• Scenario results are used to inform the Company’s business and capital plans. |
| Develop and agree management actions | • Scenario results are analysed by subject matter experts and appropriate management actions are then developed.<br>• Scenario results and management actions are reviewed and agreed by senior management through executive committees including the Executive Risk Committee, the Board Risk Committee and the Board. |

Stress testing is used widely across the Company. The diagram below summarises areas of focus:



**17. Risk management (continued)**

Specific areas that involve capital management include:
- *Strategic financial and capital planning* – by assessing the impact of sensitivities and scenarios on the capital plan and capital ratios.
- *Risk appetite* – by gaining a better understanding of the drivers of, and the underlying risks associated with, risk appetite.
- *Risk identification* – by better understanding the risks that could potentially affect the Company's financial strength and capital position.
- *Risk mitigation* – by identifying actions to mitigate risks, or those that could be taken, in the event of adverse changes to the business or economic environment. Key risk mitigating actions are documented in the Company's recovery plan.

Reverse stress testing is also carried out in order to identify circumstances that may lead to specific, defined outcomes such as business failure. Reverse stress testing allows potential vulnerabilities in the business model to be examined more fully.

*Capital sufficiency – going concern forward-looking view*
Going concern capital requirements are examined on a forward-looking basis – including as part of the annual budgeting process – by assessing the resilience of capital adequacy and leverage ratios under hypothetical future states. These assessments include assumptions about regulatory and accounting factors (such as IFRS 9). They are linked to economic variables and impairments and seek to demonstrate that the Company and its operating subsidiaries maintain sufficient capital. A range of future states are tested. In particular, capital requirements are assessed:
- Based on a forecast of future business performance, given expectations of economic and market conditions over the forecast period.
- Based on a forecast of future business performance under adverse economic and market conditions over the forecast period. Scenarios of different severity may be examined.

The examination of capital requirements under normal and adverse market conditions enables the Company to determine whether its projected business performance meets internal and regulatory capital requirements.

The examination of capital requirements under adverse economic and market conditions is assessed through stress testing. The results of stress tests are not only used widely across the Company but also by the regulators to set specific capital buffers. The Company takes part in stress tests run by regulatory authorities to test industry-wide vulnerabilities under crystallising global and domestic systemic risks.

Stress and peak-to-trough movements are used to help assess the amount of CET1 capital the Company needs to hold in stress conditions in accordance with the capital risk appetite framework.

*Internal assessment of capital adequacy*
An internal assessment of material risks is carried out annually to enable an evaluation of the amount, type and distribution of capital required to cover these risks. This is referred to as the Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP consists of a point-in-time assessment of exposures and risks at the end of the financial year together with a forward-looking stress capital assessment. The ICAAP is approved by the Board and submitted to the JFSC.

The ICAAP is used to form a view of capital adequacy separately to the minimum regulatory requirements. It is used by the JFSC to assess the Company's specific capital requirements through the Pillar 2 framework.

*Capital allocation*
The Company has mechanisms to allocate capital. These aim to optimise the use of capital resources taking into account applicable regulatory requirements; strategic and business objectives; and risk appetite. The framework for allocating capital is approved by the Assets and Liabilities Committee.

*Governance*
Capital management is subject to substantial review and governance. The Board approves the capital plans, including those for key legal entities and businesses as well as the results of the stress tests relating to those capital plans.

Stress testing – liquidity
*Liquidity risk monitoring and contingency planning*
A suite of tools is used to monitor, limit and stress test the risks on the balance sheet. Limit frameworks are in place to control the level of liquidity risk, asset and liability mismatches and funding concentrations. Liquidity risks are reviewed at significant legal entity and business levels daily, with performance reported to the Assets and Liabilities Committee on a regular basis. Liquidity Condition Indicators are monitored daily. This ensures any build-up of stress is detected early and the response escalated appropriately using the Company's recovery plan.

*Internal assessment of liquidity*
Under the liquidity risk management framework, the Company maintains an Individual Liquidity Adequacy Assessment Process. This includes assessment of net stressed liquidity outflows under a range of extreme but plausible stress scenarios detailed in the table below.

| Type | Description |
|---|---|
| Idiosyncratic scenario | The market perceives the Company to be suffering from a severe stress event, which results in an immediate assumption of increased credit risk or concerns over solvency. |
| Market-wide scenario | A market stress event affecting all participants in a market through contagion, potential counterparty failure and other market risks. The Company is affected under this scenario but no more severely than any other participants with equivalent exposure. |
| Combined scenario | This scenario models the combined impact of an idiosyncratic and market stress occurring at once, severely affecting funding markets and the liquidity of some assets. |

The Company uses the most severe combination of these to set the internal stress testing scenario which underpins its internal liquidity risk appetite. This complements the regulatory liquidity coverage ratio requirement.

Stress testing – recovery and resolution planning
The Recovery Plan explains how the Company would identify and respond to a financial stress event and restore its financial position so that it remains viable on an ongoing basis. The Company has its own recovery plan which forms part of the overall RBS Group plan.

### 17. Risk management (continued)

The recovery plan ensures risks that could delay the implementation of a recovery strategy are highlighted and preparations are made to minimise the impact of these risks. Preparations include:

- Developing a series of recovery indicators to provide early warning of potential stress events;
- Clarifying roles, responsibilities and escalation routes to minimise uncertainty or delay;
- Developing a recovery playbook to provide a concise description of the actions required during recovery;
- Detailing a range of options to address different stress conditions;
- Appointing dedicated option owners to reduce the risk of delay and capacity concerns; and
- Carrying out ‘fire drills’ to practice responding to recovery events.

The plan is intended to enable the Company to maintain critical services and products it provides to its customers, maintain its core business lines and operate within risk appetite while restoring the Company’s financial condition. It is assessed for appropriateness on an ongoing basis and is updated annually. The plan is reviewed and approved by the Board prior to submission to the JFSC each year.

Resolution would be implemented if RBS Group was assessed by the UK authorities to have failed and the appropriate regulator put it into resolution. The Bank (Recovery and Resolution) (Jersey) Law 2017 (the “Law”) has been registered by the Jersey Royal Court but is not yet in force. Once implemented, the Law will provide a new bank resolution regime for Jersey which is broadly consistent with the European Union Bank Recovery and Resolution Directive (2014/59) and the United Kingdom Banking Act 2009 (as amended). Specifically, it will establish the Jersey Resolution Authority which will be granted administrative powers to stabilise and/or resolve distressed banks.

#### Stress testing – market risk

#### Non-traded market risk

The Company produces an internal scenario analysis as part of its financial planning cycles.

Non-traded exposures are capitalised through the ICAAP. This covers gap risk, basis risk, credit spread risk, pipeline risk, structural foreign exchange risk, prepayment risk, equity risk and accounting volatility risk. The ICAAP is completed with a combination of value and earnings measures. The total non-traded market risk capital requirement is determined by adding the different charges for each sub risk type. The ICAAP methodology captures at least ten years of historical volatility, produced with 99% confidence level. Methodologies are reviewed by RBS Group Model Risk and the results are approved by the RBS Group Capital Management & Stress Testing Committee.

#### Credit risk (including counterparty risk)

#### Definition

Credit risk is the risk that customers and counterparties fail to meet their contractual obligation to settle outstanding amounts.

#### Sources of risk

The Company has exposure to entities by making placements and advances to those counterparties. The Board of Directors reviews the placement of deposits to other legal entities in RBS Group. The RBS Group is majority owned by the UK Government and draws on support provided by central banks where required in order to meet its commitments including those to the Company.

The Company also has exposure to the Bank of England, the Central Bank of Luxembourg, US correspondent banks and to the UK, US and various eurozone governments through holding government bonds in its liquid asset portfolio. These exposures are also reviewed by the Board of Directors.

#### Risk governance

The Company operates a Credit Risk function, which provides oversight of frontline credit risk management activities. Governance activities include:

- Defining credit risk appetite for the management of concentration risk and credit policy to establish the key causes of risk in the process of providing credit and the controls that must be in place to mitigate them.
- Approving and monitoring credit limits.
- Oversight of the first line of defence to ensure that credit risk remains within the appetite set by the Board and that controls are being operated adequately and effectively.

#### Risk appetite

The Company’s approach to Wholesale credit is governed by a comprehensive credit risk appetite framework. The framework is monitored and actions are taken to adapt lending criteria as appropriate. Credit risk appetite aligns to the strategic risk appetite set by the Board. The framework has been designed to reflect factors that influence the ability to operate within risk appetite. Tools such as stress testing and economic capital are used to measure credit risk volatility and develop links between the framework and risk appetite limits.

The framework is supported by a suite of transaction acceptance standards that set out the risk parameters within which businesses should operate.

The Personal credit risk appetite framework sets limits that measure and control the quality and concentration of both existing and new business for each relevant business segment. The actual performance of each portfolio is tracked relative to these limits and management action is taken where necessary. The limits apply to a range of credit risk-related measures including expected loss at both portfolio and product level, projected credit default rates across products and the loan-to-value (LTV) ratio of the Personal mortgage portfolios.

For the Wholesale credit risk appetite framework, the four formal frameworks used – and their basis for classification – are detailed in the following table.

| Framework | Basis for classification | |
|---|---|---|
| | Measure | Other |
| Single name concentration | Exposure | Risk – based on loss given default for a given probability of default |
| Sector | Exposure | Risk – based on economic capital and other qualitative factors |
| Country | Exposure | Risk – based on sovereign default risk, political stability and macroeconomic factors |
| Product and asset class | Exposure | Risk – based on heightened risk characteristics |

#### Risk controls

Credit policy standards are in place for both the Wholesale and Personal portfolios. They are expressed as a set of mandatory controls.

**17. Risk management (continued)**

### Risk identification and measurement

*Credit stewardship*

Risks are identified through relationship management and/or credit stewardship of portfolios or customers. Credit risk stewardship takes place throughout the customer relationship, beginning with the initial approval. It includes the application of credit assessment standards, credit risk mitigation and collateral, ensuring that credit documentation is complete and appropriate, carrying out regular portfolio or customer reviews and problem debt identification and management.

A key aspect of credit risk stewardship is monitoring signs of customer stress, and when identified, applying appropriate debt management actions. Regulatory conservatism within the Basel models has been removed as appropriate to comply with the IFRS 9 requirement for unbiased ECL estimates.

### Risk models

Credit risk models is the collective term used to describe all models, frameworks and methodologies used to calculate probability of default (PD), exposure at default (EAD), loss given default (LGD), maturity and the production of credit grades. Credit risk models are designed to provide:

- An assessment of customer and transaction characteristics.
- A meaningful differentiation of credit risk.
- Accurate internal default, loss and exposure at default estimates that are used in the capital calculation or wider risk management purposes.

*Asset quality*

All credit grades map to an asset quality scale, used for financial reporting. For Wholesale customers, a master grading scale is used for internal management reporting across portfolios. Measures of risk exposure may be aggregated and reported at differing levels of detail depending on stakeholder or business requirements. Performing loans are defined as AQ1-AQ9 (where the PD is less than 100%) and non-performing loans as AQ10 or Stage 3 under IFRS 9 (where the PD is 100%).

*Counterparty credit risk*

The Company mitigates counterparty credit risk through collateralisation and netting agreements, which allow amounts owed by the Company to a counterparty to be netted against amounts the counterparty owes the Company.

### Risk mitigation

Risk mitigation techniques, as set out in the appropriate credit policies, are used in the management of credit portfolios across the Company. These techniques mitigate credit concentrations in relation to an individual customer, a borrower group or a collection of related borrowers. Where possible, customer credit balances are netted against obligations. Mitigation tools can include structuring a security interest in a physical or financial asset, the use of credit derivatives including credit default swaps, credit-linked debt instruments and securitisation structures, and the use of guarantees and similar instruments (for example, credit insurance) from related and third parties. Property is used to mitigate credit risk across a number of portfolios, in particular residential mortgage lending and commercial real estate (CRE).

The valuation methodologies for residential mortgage collateral and CRE are detailed below.

*Residential mortgages* – The Company takes collateral in the form of residential property to mitigate the credit risk arising from mortgages. The Company values residential property during the loan underwriting process by either appraising properties individually.

*Commercial real estate valuations* – The Company has a panel of chartered surveying firms that cover the spectrum of geography and property sectors in which the Company takes collateral. Suitable valuers for particular assets are contracted through a single service agreement to ensure consistency of quality and advice. Valuations are commissioned when an asset is taken as security; a material increase in a facility is requested; or a default event is anticipated or has occurred. In the UK, an independent third-party market indexation is applied to update external valuations once they are more than a year old and for exposure exceeding £25m every three years a formal independent valuation is commissioned. The current indexed value of the property is a component of the ECL provisioning calculation.

### Risk assessment and monitoring

Practices for credit stewardship – including credit assessment, approval and monitoring as well as the identification and management of problem debts – differ between the Personal and Wholesale portfolios.

#### Personal

Personal customers are served through a lending approach that entails making a large number of small-value loans. To ensure that these lending decisions are made consistently, the Company analyses internal credit information as well as external data supplied from credit reference agencies (including historical debt servicing behaviour of customers with respect to both the Company and other lenders). The Company then sets its lending rules accordingly, developing different rules for different products.

The process is then largely automated, with each customer receiving an individual credit score that reflects both internal and external behaviours and this score is compared with the lending rules set. For relatively high-value, complex personal loans, including some residential mortgage lending, specialist credit managers make the final lending decisions. These decisions are made within specified delegated authority limits that are issued dependent on the experience of the individual.

Underwriting standards and portfolio performance are monitored on an ongoing basis to ensure they remain adequate in the current market environment and are not weakened materially to sustain growth.

#### Wholesale

Wholesale customers – including corporates, banks and other financial institutions – are grouped by industry sectors and geography as well as by product/asset class and are managed on an individual basis. Customers are aggregated as a single risk when sufficiently interconnected.

A credit assessment is carried out before credit facilities are made available to customers. The assessment process is dependent on the complexity of the transaction.

For lower risk transactions below specific thresholds, credit decisions can be approved through self-sanctioning within the business. This process is facilitated through an auto-decision making system, which utilises scorecards, strategies and policy rules. Such credit decisions must be within the approval authority of the relevant business sanctioner.

For all other transactions credit is only granted to customers following joint approval by an approver from the business and the credit risk function, or by two credit officers. The joint business and credit approvers act within a delegated approval authority under the Wholesale Credit Authorities Framework Policy.

The level of delegated authority held by approvers is dependent on their experience and expertise with only a small number of senior executives holding the highest approval authority.

## 17. Risk management (continued)

Both business and credit approvers are accountable for the quality of each decision taken, although the credit risk approver holds ultimate sanctioning authority.

Transaction Acceptance Standards provide detailed transactional lending and risk acceptance metrics and structuring guidance. As such, these standards provide a mechanism to manage risk appetite at the customer/transaction level and are supplementary to the established credit risk appetite.

Credit grades (PD and LGD) are reviewed and if appropriate re-approved annually. The review process assesses borrower performance, including reconfirmation or adjustment of risk parameter estimates; the adequacy of security; compliance with terms and conditions; and refinancing risk.

### Problem debt management

#### Personal

*Early problem identification*

Pre-emptive triggers are in place to help identify customers that may be at risk of being in financial difficulty. These triggers are both internal, using the Company's data, and external using information from credit reference agencies. Pro-active contact is then made with the customer to establish if they require help with managing their finances. By adopting this approach, the aim is to prevent a customer's financial position deteriorating which may then require intervention from the Collections and Recoveries teams.

*Collections*

When a customer exceeds an agreed limit or misses a regular monthly payment the customer is contacted by the Company and requested to remedy the position.

If the situation is not regularised then, where appropriate, the Collections team will become more fully involved and the customer will be supported by skilled debt management staff who endeavour to provide customers with bespoke solutions. Solutions include short-term account restructuring, refinance loans and forbearance which can include interest suspension and 'breathing space'. In the event that an affordable/sustainable agreement with a customer cannot be reached, the debt will transition to the Recoveries team. For provisioning purposes, under IFRS 9, exposure to customers managed by the Collections team is categorised as Stage 2 and subject to a lifetime loss assessment, unless it is 90 days past due, in which case it is categorised as Stage 3.

*Recoveries*

The Recoveries team will issue a notice of intention to default to the customer and, if appropriate, a formal demand, while also registering the account with credit reference agencies where appropriate. Following this, the customer's debt may then be placed with a third-party debt collection agency, or alternatively a solicitor, in order to agree an affordable repayment plan with the customer. An option that may also be considered is the sale of unsecured debt. Exposures subject to formal debt recovery are defaulted and categorised as Stage 3 impaired.

#### Wholesale

*Early problem identification*

Each segment and sector has defined early warning indicators to identify customers experiencing financial difficulty, and to increase monitoring if needed. Early warning indicators may be internal, such as a customer's bank account activity, or external, such as a publicly-listed customer's share price. If early warning indicators show a customer is experiencing potential or actual difficulty, or if relationship managers or credit officers identify other signs of financial difficulty, they may decide to classify the customer within the Risk of Credit Loss framework.

*Risk of Credit Loss framework*

The Risk of Credit loss framework is used where the credit profile of a Wholesale customer has deteriorated. Experienced credit risk officers apply expert judgement to classify cases into categories that reflect progressively deteriorating credit risk. There are two classifications in the framework that apply to non-defaulted customers – Heightened Monitoring and Risk of Credit Loss. For the purposes of provisioning, all exposures subject to the framework are categorised as Stage 2 and subject to a lifetime loss assessment. The framework also applies to those customers that have met the Company's default criteria (AQ10 exposures). Defaulted exposures are categorised as Stage 3 impaired for provisioning purposes.

Customers classified in the Heightened Monitoring category are those who are still performing but have certain characteristics – such as trading issues, covenant breaches, material PD downgrades and past due facilities – that may affect the ability to meet repayment obligations. Heightened Monitoring customers require pre-emptive actions to return or maintain their facilities within risk appetite prior to maturity.

Risk of Credit Loss customers are performing customers that have met the criteria for Heightened Monitoring and also pose a risk of credit loss to the Company in the next 12 months should mitigating action not be taken or if the action taken not be successful.

Once classified as either Heightened Monitoring or Risk of Credit Loss, a number of mandatory actions are taken – including a review of the customer's credit grade, facility and security documentation and the valuation of security. Depending on the severity of the financial difficulty and the size of the exposure, the customer relationship strategy is reassessed by credit officers, by specialist credit risk or relationship management units in the relevant business, or by Restructuring.

*Restructuring*

For the Wholesale problem debt portfolio, customer relationships are mainly managed by the Restructuring team. The purpose of Restructuring is to protect the Company's capital. Where practicable, Restructuring does this by working with corporate and commercial customers to support their turnaround and recovery strategies and enable them to return to mainstream banking. Restructuring will always aim to recover capital in a fair and efficient manner.

Specialists in Restructuring work with customers experiencing financial difficulties and showing signs of financial stress. Throughout Restructuring's involvement the mainstream relationship manager will remain an integral part of the customer relationship, unless an exit strategy is deemed appropriate. The objective is to find a mutually acceptable solution, including restructuring of existing facilities, repayment or refinancing.

Where a solvent outcome is not possible, insolvency may be considered as a last resort. However, helping the customer return to financial health and restoring a normal banking relationship is always the preferred outcome.

### Forbearance

Forbearance takes place when a concession is made on the contractual terms of a loan/debt in response to a customer's financial difficulties.

The aim of forbearance is to support and restore the customer to financial health while minimising risk. To ensure that forbearance is appropriate for the needs of the customer, minimum standards are applied when assessing, recording, monitoring and reporting forbearance.

## 17. Risk management (continued)

A loan/debt may be forborne more than once, generally where a temporary concession has been granted and circumstances warrant another temporary or permanent revision of the loan's terms.

In the Personal portfolio, loans are considered forborne until they meet the exit criteria set out by the European Banking Authority. These include being classified as performing for two years since the last forbearance event, making regular repayments and the loan/debt being less than 30 days past due. Exit criteria are not currently applied for Wholesale portfolios.

### Types of forbearance

*Personal*

In the Personal portfolio, forbearance may involve payment concessions and loan rescheduling (including extensions in contractual maturity) and capitalisation of arrears. Forbearance is granted principally to customers with mortgages and less frequently to customers with unsecured loans. This includes instances where forbearance may be provided to customers with highly flexible mortgages.

*Wholesale*

In the Wholesale portfolio, forbearance may involve covenant waivers, amendments to margins, payment concessions and loan rescheduling (including extensions in contractual maturity), capitalisation of arrears, and debt forgiveness or debt-for-equity swaps.

### Monitoring of forbearance

*Personal*

For Personal portfolios, forborne loans are separated and regularly monitored and reported while the forbearance strategy is implemented until they exit forbearance.

*Wholesale*

In the Wholesale portfolio, customer PDs and facility LGDs are re-assessed prior to finalising any forbearance arrangement. The ultimate outcome of a forbearance strategy is highly dependent on the cooperation of the borrower and a viable business or repayment outcome. Where forbearance is no longer appropriate, the Company will consider other options such as the enforcement of security, insolvency proceedings or both, although these are options of last resort.

### Provisioning for forbearance

*Personal*

The methodology used for provisioning in respect of Personal forborne loans will differ depending on whether the loans are performing or non-performing and which business is managing them due to local market conditions.

Granting forbearance will only change the arrears status of the loan in specific circumstances, which can include capitalisation of principal and interest in arrears, where the loan may be returned to the performing book if the customer has demonstrated an ability to meet regular payments and is likely to continue to do so.

The loan would remain in forbearance for the defined probation period and be subject to performance criteria. These include making regular repayments and being less than 30 days past due.
Additionally, for some forbearance types a loan may be transferred to the performing book if a customer makes payments that reduce loan arrears below 90 days.
For ECL provisioning, all forborne but performing exposures are categorised as Stage 2 and are subject to a lifetime loss provisioning assessment.

For non-performing forborne loans, the Stage 3 loss assessment process is the same as for non-forborne loans.

*Wholesale*

Provisions for forborne loans are assessed in accordance with normal provisioning policies. The customer's financial position and prospects – as well as the likely effect of the forbearance, including any concessions granted, and revised PD or LGD gradings – are considered in order to establish whether an impairment provision is required.

Wholesale loans granted forbearance are individually assessed in most cases. Performing loans subject to forbearance treatment are categorised as Stage 2 and subject to a lifetime loss assessment. Forbearance may result in the value of the outstanding debt exceeding the present value of the estimated future cash flows. This difference will lead to a customer being classified as non-performing.

In the case of non-performing forborne loans, an individual loan impairment provision assessment generally takes place prior to forbearance being granted. The amount of the loan impairment provision may change once the terms of the forbearance are known, resulting in an additional provision charge or a release of the provision in the period the forbearance is granted.

The transfer of Wholesale loans from impaired to performing status follows assessment by relationship managers and credit. When no further losses are anticipated and the customer is expected to meet the loan's revised terms, any provision is written-off or released and the balance of the loan returned to performing status. This is not dependent on a specified time period and follows the credit risk manager's assessment.

### Impairment, provisioning and write-offs

In the overall assessment of credit risk, impairment provisioning and write-offs are used as key indicators of credit quality.

RBS Group's IFRS 9 provisioning models, which used existing Basel models as a starting point, incorporate term structures and forward-looking information.

Five key areas may materially influence the measurement of credit impairment under IFRS 9 – two of these relate to model build and three relate to their application:

- Model build:
  - The determination of economic indicators that have most influence on credit loss for each portfolio and the severity of impact (this leverages existing stress testing mechanisms).
  - The build of term structures to extend the determination of the risk of loss beyond 12 months that will influence the impact of lifetime loss for assets in Stage 2.
- Model application:
  - The assessment of the significant increase in credit risk and the formation of a framework capable of consistent application.
  - The determination of asset lifetimes that reflect behavioural characteristics while also representing management actions and processes (using historical data and experience).
  - The determination of a base case (or central) economic scenario which has the most material impact (of all forward-looking scenarios) on the measurement of loss (RBS Group uses consensus forecasts to remove management bias).

### Economic loss drivers

Introduction

The most material economic loss drivers for Personal portfolios include notional GDP, unemployment rate, house price indices, and base rate for the UK. In addition to some of these loss drivers, world GDP is a primary loss driver for Wholesale portfolios.

## 17. Risk management (continued)

### Central base case economic scenario

The internal base case scenario is the primary forward-looking economic information driving the calculation of ECL. The same base case scenario is used for financial planning by the Company with the exception of the yield curve, as a result of the different timing of the exercises. The key elements of the current economic base case, which includes forecasts over a five year forecast horizon, are summarised as follows.

- United Kingdom: The central base case economic scenario projects modest growth in the UK economy, in line with the consensus outlook. Brexit related uncertainty results in subdued confidence in the near term, placing it in the lower quartile of advanced economies. Business investment is weak at the start of the forecast, improving only gradually. Consumer spending rises steadily as households benefit from falling inflation and rising wage growth, though it is a modest upturn. The central scenario assumes slower job growth than seen in recent years, meaning unemployment edges up from its current historic lows. House price growth slows, extending the current slowdown, before picking up to low single digit growth in later years. Monetary policy follows the market implied path for Bank of England base rate at the time the scenarios were set, therefore it is assumed there are two base rate cuts over the next five years, whereas the yield curve used for financial planning assumes one base rate cut.

*Use of the central base case in Retail*

In Retail, the internal base case is directly used as the central scenario for the ECL calculations by feeding the forecasted economic loss drivers into the respective PD and LGD models

*Use of the central base case in Wholesale*

As in Retail, the primary input is the central base case scenario but a further adjustment is applied to the aggregate credit cycle conditions arising from the base case to explicitly enforce a gradual reversion to long run average conditions starting from the first projected year onwards.

The application of the mean reversion adjustment is based on two empirical observations. Firstly, historic credit loss rates in Wholesale portfolios show pronounced mean reversion behaviour and secondly, the accuracy of economic forecasts tends to drop significantly for horizons beyond one or two years.

### Approach for multiple economic scenarios (MES)

The base case economic scenario is the primary driver of the calculation of ECL, and is an integral component within the Company's approach to MES.

RBS International Retail remains Basel standardised for risk-weighted assets, therefore modelled probability of default (PDs) and loss given default (LGDs) are not available for calculating stage 1 and stage 2 ECLs. Instead this is undertaken by sourcing the equivalent product PD & LGD from within NatWest UK Personal, which was identified as the closest comparable portfolio to RBS International Retail. The PD and LGD benchmarks are then used, along with the known exposure, to calculate an account level ECL.

In order to identify accounts showing stage 2 credit deterioration the RBS International Retail Watch classification is applied where accounts are identified as having clear signs of credit deterioration, increased risk of default and/or loss or have been given forbearance, with days past due being checked as supplementary back stop.

The response of portfolio loss rates to changes in economic conditions is typically non-linear and asymmetric. Therefore, in order to appropriately take account of the uncertainty in economic forecasts a range of economic scenarios is considered when calculating ECL.

- Retail – In addition to the central base case a further four bespoke scenarios are taken into account – a base case upside and downside – and an additional upside and downside. The overall MES ECL is calculated as a probability weighted average across all five scenarios. (Refer to the Probability weightings of scenarios section below).

The ECL impact on the Retail portfolio arising from the application of MES over the single, central base case will be negligible at less than £50k. Following review by the Provisions Committee, overlays were agreed to ensure the expected effect of non-linearity of losses was appropriately recognised.

- Wholesale – the approach to MES is a Monte Carlo method that involves simulating a large number of alternative scenarios around the central scenario (adjusted for mean reversion) and averaging the losses and PD values for each individual scenario into unbiased expectations of losses (ECL) and PD.

The simulation of alternative scenarios does not occur on the level of the individual economic loss drivers but operates on the aggregate Credit Cycle Indices (CCI) that underpin the Wholesale credit models. The CCI are constructed by summarising market data based point-in-time PDs for all publicly listed entities in the respective region/industry grouping on a monthly frequency. Positive CCI values indicate better than average conditions, i.e low default rates and a CCI value of zero indicates default rate conditions at long run average levels. The CCI can be interpreted as an aggregation of the primary economic loss drivers most relevant for each portfolio segment into a single measure.

The Monte Carlo MES approach increases Wholesale ECL for Stage 1 and Stage 2 by approximately 7% (2018: 5%) above the single, central scenario outcomes. No additional MES overlay was applied for Wholesale, with the final reported ECL inclusive of the systematic MES uplift from the Monte Carlo modelling.

For both Retail and Wholesale, the impact from MES is factored into account level PDs through scalars. These MES-adjusted PDs are used to assess whether a significant increase in credit risk has occurred.

### Key economic loss drivers

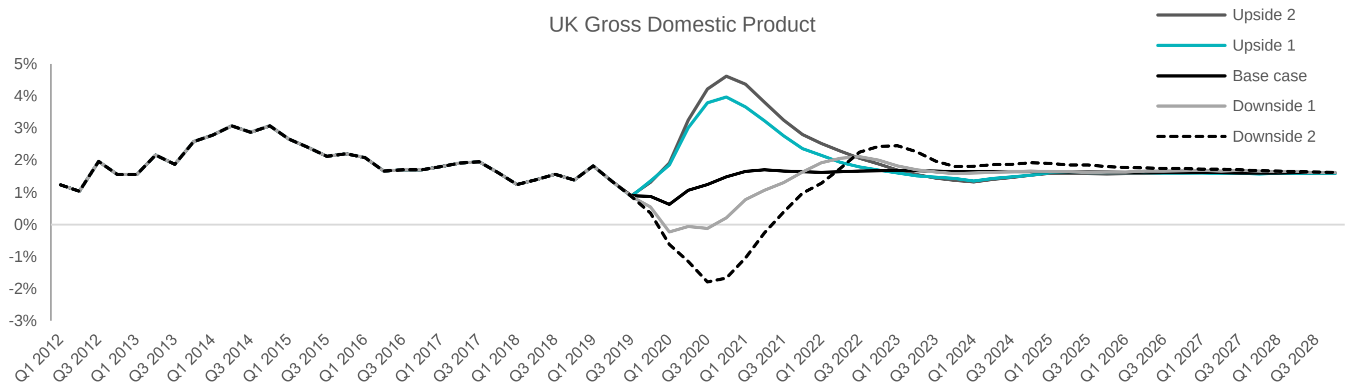
The tables and commentary below provide an update on the base case economics used at 31 December 2019, and also the MES used for Personal portfolios. The average over the five year horizon (2020 to 2024) for the central base case and two upside and downside scenarios used for ECL modelling, are set out below. It is compared with the five year average (2019 to 2023) of the 2018 scenarios.

The graph shows the quarterly GDP year-on-year growth rates across the MES. Subsequently, the annual figures for key variables across the UK are shown. Finally, the extreme points table show the best and worst readings for three key variables in the two upside and two downside scenarios, highlighting the most challenging points in the downside scenarios and the strongest points in the upside scenarios.

The 2019 base case GDP growth and interest rate assumptions are pessimistic compared to 2018 as consensus outlook and market implied interest rate projections worsened over the year. Unemployment rate projections are less extreme in the 2019 downside scenarios as RBS Group aimed to align the Downside 2 scenario with Office for Budget Responsibility's analysis of a hard Brexit scenario.

## 17. Risk management (continued)

| UK | 2019 Upside 2 % | 2019 Upside 1 % | 2019 Base case % | 2019 Downside 1 % | 2019 Downside 2 % | 2018 Upside 2 % | 2018 Upside 1 % | 2018 Base case % | 2018 Downside 1 % | 2018 Downside 2 % |
|---|---|---|---|---|---|---|---|---|---|---|
| GDP - change | 2.4 | 2.2 | 1.6 | 1.3 | 0.9 | 2.6 | 2.3 | 1.7 | 1.5 | 1.1 |
| Unemployment | 3.6 | 3.9 | 4.4 | 4.7 | 5.2 | 3.3 | 3.8 | 5.0 | 5.6 | 6.9 |
| House Price Inflation - change | 4.1 | 3.3 | 1.6 | 0.8 | (1.0) | 4.3 | 3.3 | 1.7 | 1.1 | (0.5) |
| Bank of England base rate | 1.0 | 0.7 | 0.3 | — | — | 1.7 | 1.3 | 1.1 | 0.5 | — |
| World GDP - change | 3.8 | 3.3 | 2.8 | 2.5 | 2.1 | 3.6 | 3.2 | 2.7 | 2.5 | 2.3 |
| Probability weight | 12.7 | 14.8 | 30.0 | 29.7 | 12.7 | 12.8 | 17.0 | 30.0 | 25.6 | 14.6 |




### UK GDP - annual growth

| | Upside 2 % | Upside 1 % | Base case % | Downside 1 % | Downside 2 % |
|---|---|---|---|---|---|
| 2019 | 1.3 | 1.4 | 1.2 | 1.1 | 1.1 |
| 2020 | 3.5 | 3.2 | 1.1 | (0.1) | (1.3) |
| 2021 | 3.6 | 3.0 | 1.7 | 1.2 | — |
| 2022 | 2.2 | 1.9 | 1.7 | 2.0 | 1.9 |
| 2023 | 1.5 | 1.5 | 1.7 | 1.7 | 2.1 |
| 2024 | 1.4 | 1.5 | 1.6 | 1.6 | 1.9 |

### UK unemployment rate

| | Upside 2 % | Upside 1 % | Base case % | Downside 1 % | Downside 2 % |
|---|---|---|---|---|---|
| Q4 2019 | 4.0 | 4.0 | 4.1 | 4.1 | 4.1 |
| Q4 2020 | 3.7 | 3.8 | 4.4 | 4.8 | 5.1 |
| Q4 2021 | 3.5 | 3.8 | 4.4 | 4.8 | 5.5 |
| Q4 2022 | 3.5 | 3.8 | 4.4 | 4.7 | 5.4 |
| Q4 2023 | 3.6 | 3.9 | 4.4 | 4.6 | 5.3 |
| Q4 2024 | 3.8 | 4.0 | 4.4 | 4.6 | 5.1 |

### UK House Price Inflation - annual growth

| | Upside 2 % | Upside 1 % | Base case % | Downside 1 % | Downside 2 % |
|---|---|---|---|---|---|
| 2019 | 1.7 | 1.7 | 1.5 | 1.5 | 1.4 |
| 2020 | 5.7 | 4.5 | 1.0 | (1.1) | (3.6) |
| 2021 | 8.2 | 6.0 | 0.9 | (2.7) | (7.7) |
| 2022 | 4.2 | 3.1 | 1.5 | 0.8 | (1.9) |
| 2023 | 1.7 | 1.4 | 2.0 | 3.1 | 3.0 |
| 2024 | 0.9 | 1.4 | 2.6 | 3.9 | 5.2 |

| | Worst points | | | | Best points | | | |
|---|---|---|---|---|---|---|---|---|
| | H2 2019 | | H2 2018 | | H2 2019 | | H2 2018 | |
| UK | Upside 2 % | Upside 1 % | Upside 2 % | Upside 1 % | Downside 1 % | Downside 2 % | Downside 1 % | Downside 2 % |
| GDP (year-on-year) | 4.6 | 4.0 | 5.0 | 4.1 | (0.2) | (1.8) | (0.1) | (1.9) |
| Unemployment | 3.5 | 3.8 | 2.8 | 3.4 | 4.9 | 5.5 | 5.9 | 7.4 |
| House Price Inflation (year-on-year) | 8.9 | 6.7 | 9.1 | 7.0 | (3.5) | (8.4) | (2.8) | (7.3) |

**17. Risk management (continued)**

**Credit risk continued**

Probability weightings of scenarios (audited)
The Company's approach to IFRS 9 MES in Retail involves selecting a suitable set of discrete scenarios to characterise the distribution of risks in the economic outlook and assigning appropriate probability weights to those scenarios. This involves the following steps:

- Scenario selection – Two upside and two downside scenarios from Moody's inventory of scenarios were chosen. The aim is to obtain downside scenarios that are not as severe as stress tests, so typically they have a severity of around one in ten and one in five of approximate likelihood, along with corresponding upsides.
- Severity assessment – Having selected the most appropriate scenarios their severity is then assessed based on the behaviour of UK GDP by calculating a variety of measures such as average growth, deviation from baseline and peak to trough falls. These measures are compared against a set of 1,000 model runs, following which, a percentile in the distribution is established which most closely corresponds to the scenario.
- Probability assignment – Having established the relevant percentile points, probability weights are assigned to ensure that the scenarios produce an unbiased result.

UK economic uncertainty
This analysis has been prepared during the run up to the UK leaving the European Union and as a result there is greater than usual uncertainty over the UK economic outlook. Our approach to capturing that elevated uncertainty is to apply an overlay to MES that is based on recognising a proportion of the ECL of a downside scenario that captures key elements of an alternative path the economy could take.

**Credit risk modelling**
ECLs are calculated using a combination of:
- Probability of default.
- Loss given default.
- Exposure at default.

In addition, lifetime PDs (as at reporting date and at date of initial recognition) are used in the assessment of the significant increase in credit risk criteria.

IFRS 9 ECL model design principles
To meet IFRS 9 requirements, PD, LGD and EAD used in ECL calculations must be:
- Unbiased – material regulatory conservatism has been removed to produce unbiased model estimates.
- Point-in-time – recognise current economic conditions.
- Forward-looking – incorporated into PD estimates and, where appropriate, EAD and LGD estimates.
- For the life of the loan – all PD, LGD and EAD models produce term structures to allow a lifetime calculation for assets in Stage 2 and Stage 3.

IFRS 9 requires that at each reporting date, an entity shall assess whether the credit risk on an account has increased significantly since initial recognition. Part of this assessment requires a comparison to be made between the current lifetime PD (i.e. the probability of default over the remaining lifetime at the reporting date) with the equivalent lifetime PD as determined at the date of initial recognition.

For assets originated before IFRS 9 was introduced, comparable lifetime origination PDs did not exist. These have been retrospectively created using the relevant model inputs applicable at initial recognition.

PD estimates
Wholesale PD models use the existing CCI based point-in-time/through-the-cycle framework to convert one-year regulatory PDs into point-in-time estimates that reflect economic conditions observed at the reporting date across a comprehensive set of region/industry segments.

One year point-in-time PDs are subsequently extended to life-time PDs using a conditional transition matrix approach. The conditional transition matrix approach allows for the incorporation of forward-looking economic information into the life-time PDs.

LGD estimates
The general approach for the IFRS 9 LGD models is to leverage corresponding Basel LGD models with bespoke adjustments to ensure estimates are unbiased and where relevant forward-looking.

Forward-looking economic information is incorporated into LGD estimates using the existing CCI framework. For low default portfolios, including sovereigns and banks, loss data is too scarce to substantiate estimates that vary with economic conditions. Consequently, for these portfolios, LGD estimates are assumed to be constant throughout the projection horizon.

EAD estimates
*Retail*
The IFRS 9 Personal modelling approach for EAD is dependent on product type.
- Revolving products use the existing Basel models as a basis, with appropriate adjustments incorporating a term structure based on time to default.
- Amortising products use an amortising schedule, where a formula is used to calculate the expected balance based on remaining terms and interest rates.
- There is no EAD model for Personal loans. Instead, debt flow (i.e. combined PD x EAD) is directly modelled.

Analysis has indicated that there is minimal impact on EAD arising from changes in the economy for all Retail portfolios except mortgages. Therefore, forward-looking information is only incorporated in the mortgage EAD model (through forecast changes in interest rates) with the equivalent lifetime PD as determined at the date of initial recognition.

*Wholesale*
For Wholesale, EAD values are projected using product specific credit conversion factors (CCF), closely following the product segmentation and approach of the respective Basel model. However, the CCFs are estimated over multi-year time horizons to produce unbiased model estimates.

No explicit forward-looking information is incorporated, on the basis that analysis has shown that temporal variations in CCFs are largely attributable to changes in exposure management practices rather than economic conditions.

Governance and post model adjustments
The IFRS 9 PD, EAD and LGD models are subject to RBS's model risk policy that stipulates periodic model monitoring, periodic re-validation and defines approval procedures and authorities according to model materiality. Post model adjustments are applied where necessary to incorporate the most recent data available and are made on a temporary basis ahead of the underlying model parameter changes being implemented.

## 17. Risk management (continued)

### Credit risk continued

### Significant increase in credit risk

Exposures that are considered to have significantly credit deteriorated since initial recognition are classified in Stage 2 and assessed for lifetime ECL measurement (exposures not considered to have deteriorated carry a 12 month ECL). RBS has adopted a framework to identify deterioration based primarily on movements in probability of default supported by additional backstops. The principles applied are consistent across RBS Group and align to credit risk management practices.

The framework comprises the following elements:

- IFRS 9 lifetime PD assessment (the primary driver) – on modelled portfolios the assessment is based on the relative deterioration in forward-looking lifetime PD and is assessed monthly. To assess whether credit deterioration has occurred, the residual lifetime PD at balance sheet date (which PD is established at date of initial recognition (DOIR)) is compared to the current PD. If the current lifetime PD exceeds the residual origination PD by more than a threshold amount deterioration is assumed to have occurred and the exposure transferred to Stage 2 for a lifetime loss assessment. For Wholesale, a doubling of PD would indicate a significant increase in credit risk subject to a minimum PD uplift of 0.1%. For Retail portfolios, the criteria varies by risk band, with lower risk exposures needing to deteriorate more than higher risk exposures, as outlined in the following table:

| Retail risk bands | Risk bandings (based on residual lifetime PD calculated at DOIR) | PD deterioration threshold criteria |
|---|---|---|
| Risk band A | <0.762% | PD@DOIR + 1% |
| Risk band B | <4.306% | PD@DOIR + 3% |
| Risk band C | >=4.306% | 1.7 x PD@DOIR |

Qualitative high-risk backstops – the PD assessment is complemented with the use of qualitative high-risk backstops to further inform whether significant deterioration in lifetime risk of default has occurred. The qualitative high-risk backstop assessment includes the use of the mandatory 30+ days past due backstop, as prescribed by IFRS 9 guidance.

### Asset lifetimes

The choice of initial recognition and asset duration is another critical judgement in determining the quantum of lifetime losses that apply.

- The date of initial recognition reflects the date that a transaction (or account) was first recognised on the balance sheet; the PD recorded at that time provides the baseline used for subsequent determination of significant increase in credit risk.
- For asset duration, the approach applied (in line with IFRS 9 requirements) is:
  - Term lending – the contractual maturity date, reduced for behavioural trends where appropriate (such as, expected pre-payment and amortisation).

#### Retail non-modelled portfolio

RBSI Retail remains Basel standardised for Risk Weighted Assets, therefore modelled Probability of Default (PDs) and Loss Given Default (LGDs) are not available for calculating stage 1 and stage 2 ECLs. Instead this is undertaken by sourcing the equivalent product PD & LGD from within NatWest UK, which was identified as the closest comparable portfolio to RBSI Retail. The PD and LGD benchmarks are then used, along with the known exposure, to calculate an account level ECL.

In order to identify accounts showing stage 2 the RBSI Retail Watch classification is applied where accounts are identified as having clear signs of credit deterioration, increased risk of default or have been given forbearance, with days past due being checked as supplementary back stop.

#### Retail adjustments for legacy Spanish and UK buy to let currency mortgages

Within RBSI Retail we continue to manage down two legacy mortgage portfolios that closed for new business in 2009 and which provided currency mortgages on Spanish and UK buy to let (B2L) properties. The majority of these two legacy portfolios were provided on interest only repayment terms ranging between 10 to 30 years and where sale of the property was considered as an acceptable repayment source.

The peak maturity period for Spanish mortgages occurred between 2016 and 2018, with a small proportion remaining with longer dated maturities running until 2032. However following the crash in the Spanish property market a large proportion of the portfolio has matured or is expected to mature with either higher LTVs above 75% or even negative equity.

UK B2L currency mortgages were also predominately lent on interest only with maturities running until 2036 and the majority of the portfolio (c70%) still has more than five years to run. Due to historic exchange rate volatility and the associated cross currency risk a proportion of the portfolio is now in excess of our normal B2L LTV appetite of 75%.

The non-modelled portfolio ECL calculation applied to RBSI Retail does not take into account the increased risk of loss associated with interest only repayment and higher LTV profiles, resulting in an unrealistically small ECL for the Spanish and UK B2L currency mortgage books. As a result, an adjustment is required to reflect the actual credit loss experience and is applied to accounts showing signs of credit deterioration through their Watch classification status (e.g. increased LTV, high risk of default or forbearance given) or through the days past due back stop.

Once the ECL adjustments are applied this results in combined stage 1 and 2 provision coverage ratios of 2.88% and 0.13% respectively for the Spanish (£54m) and UK B2L (£112m) currency mortgage books.

### Measurement uncertainty and ECL sensitivity analysis

The recognition and measurement of ECL is complex and involves the use of significant judgement and estimation. This includes the formulation and incorporation of multiple forward-looking economic conditions into ECL to meet the measurement objective of IFRS 9. The ECL provision is sensitive to the model inputs and economic assumptions underlying the estimate. Set out below is the impact of some of the material sensitivities considered for 2019 year end reporting. These ECL simulations are separate to the impact arising from MES and UK economic uncertainty as described earlier in this disclosure, which impacts are embedded in the reported ECL.

The primary focus of the simulations is on ECL provisioning requirements on performing exposures in Stage 1 and Stage 2. The simulations are run on a stand-alone basis and are independent of each other; the potential ECL uplifts reflect the simulated impact as at the year end balance sheet date. As default is an observed event as at the balance sheet date, Stage 3 provisions are not subject to the same level of measurement uncertainty, and therefore have not been considered in this analysis, with the exception of a univariate HPI sensitivity. The following common scenarios have been applied across the key Personal and Wholesale portfolios:

- Economic uncertainty – simulating the impact arising from the Downside 2 and Upside 2 scenarios, which are two of the five discrete scenarios used in the methodology for Personal MES. In the simulation, the bank has assumed that the economic macro variables associated with these scenarios replace the existing base case economic assumptions, giving them a 100% probability weighting and thus serving as a single economic scenario.

### 17. Risk management (continued)

#### Credit risk continued

These scenarios have been applied to all modelled portfolios in the analysis below, with the simulation impacting both PDs and LGDs. Modelled overlays present in the underlying ECL estimates are also sensitised.

As expected, the scenarios create differing impacts on ECL by portfolio and the impacts are deemed reasonable. In this simulation it is assumed that existing modelled relationships between key economic variables and loss drivers hold but in practice other factors would also have an impact, e.g. potential customer behaviour changes, policy changes by lenders that might impact on the wider availability of credit.

These broader economic scenarios were complemented with two specific portfolio simulations:

- Wholesale portfolios – simulating the impact of PDs and LGDs moving upwards to the through-the-cycle (TTC) average from their current point-in-time (PIT) estimate. With the current relatively benign economic conditions Wholesale IFRS 9 PIT PDs are significantly lower than TTC PD.

  This scenario shows the increase to ECL by immediately switching to TTC measures providing an indication of long run average expectations. IFRS 9 measures have been used so there remains some differences to Basel TTC equivalent measures, where conservative assumptions are required, such as caps or floors, not permitted under the IFRS 9 best estimate approach.
- Mortgages – House Price Inflation (HPI) is a key economic driver and RBS Group have simulated a univariate scenario of a 20% decrease in HPI across the main mortgage portfolios. A univariate analysis using only HPI does not allow for the interdependence across the other key primary loss drivers to be reflected in any ECL estimate. PDs are not impacted in this scenario analysis. The simulated impact is based on 100% probability weighting to demonstrate the isolated sensitivity of HPI against base ECL estimates.

The Company's core criterion to identify a significant increase in credit risk is founded on PD deterioration, as discussed above. Under the simulations, PDs increase and result in exposures moving from Stage 1 to Stage 2 contributing to the ECL impact.

| | Actual Position 31 December 2019 | | Common Scenarios (2,3) | | | |
|---|---|---|---|---|---|---|
| | Stage 1 and Stage 2 (1) | | Downside 2 | | Upside 2 | |
| | Exposure | ECL Provision (2) | Potential | ECL Impact | Potential | ECL Impact |
| | £bn | £m | £m | % | £m | % |
| Retail | 2.85 | 1.69 | 0.25 | 14.7% | (0.20) | (12.1%) |
| Wholesale | 29.42 | 7.62 | 1.25 | 16.4% | (0.80) | (10.7%) |
| Total | 32.27 | 9.31 | 1.50 | 16.1% | (1.00) | (11.0%) |

Notes:
(1) Reflects drawn exposure and ECL for all modelled exposure in scope for IFRS 9; in addition to loans this includes bonds, and cash.
(2) The ECL provision includes the ECL overlays taken to recognise elevated Brexit related economic uncertainty and an increase in Heightened Monitoring volumes in the Corporate Retail Estate (CRE) retail tenanted sector.
(3) All simulations are run on a stand-alone basis and are independent of each other, with the potential ECL impact reflecting the simulated impact at the year end balance sheet date.

#### ECL Flow Statement

The table below shows the key elements that drive the movement of ECL and related income statement over the reporting period, including the following key elements:

| | Stage 1 | | Stage 2 | | Stage 3 | | Total | |
|---|---|---|---|---|---|---|---|---|
| | Loans | ECL | Loans | ECL | Loans | ECL | Loans | ECL |
| RBS International | £m | £m | £m | £m | £m | £m | £m | £m |
| At 1 January 2019* | 26,749 | 6 | 276 | 3 | 101 | 23 | 27,126 | 32 |
| Currency translation and other adjustments | (670) | (1) | (5) | 1 | (2) | (1) | (677) | (1) |
| Inter-group transfers | (772) | - | (27) | (1) | - | - | (799) | (1) |
| Transfers from Stage 1 to Stage 2 | (864) | (2) | 864 | 2 | - | - | - | - |
| Transfers from Stage 2 to Stage 1 | 674 | 5 | (674) | (5) | - | - | - | - |
| Transfers to Stage 3 | (22) | - | (71) | - | 93 | - | - | - |
| Transfers from Stage 3 | 11 | - | 11 | - | (22) | - | - | - |
| Net re-measurement of ECL on stage transfer | | (4) | | 2 | | 3 | | 1 |
| Changes in risk parameters (model inputs) | | (2) | | 4 | | 7 | | 9 |
| Other changes in net exposure | 8,342 | 1 | 274 | - | (31) | (6) | 8,585 | (5) |
| Other (P&L only items) | | - | | - | | (3) | | (3) |
| Income statement (releases)/charges | | (5) | | 6 | | 1 | | 2 |
| Amounts written-off | - | - | - | - | (4) | (4) | (4) | (4) |
| Unwinding of discount | | - | | - | | (1) | - | (1) |
| At 31 December 2019 | 33,448 | 3 | 648 | 6 | 135 | 21 | 34,231 | 30 |
| Net carrying amount | 33,445 | | 642 | | 114 | | 34,201 | |

*2018 data has been restated for a change to presentation of unrecognised interest. Refer to Accounting policy 1, Other amendments to IFRS, for further details.

## 17. Risk management (continued)

### Credit risk continued

| | ECL Stage 1 | ECL Stage 2 | ECL Stage 3 | Total |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| At 1 January 2018 | 2 | 3 | 5 | 10 |
| 2018 movements | 4 | - | 18 | 22 |
| At 31 December 2018* | 6 | 3 | 23 | 32 |

*Note:
- Due to change in accounting policy in line with the IFRIC decision, ECL allowance on the balance sheet have been adjusted and the comparative period restated by £6m with no effect on the income statement or equity.
- Due to presentational change in 2019, ECL balances now includes ECL on loans and advances and contingent liabilities. Accordingly comparatives have been adjusted by £2m.

Maximum credit risk exposure and significant concentrations of credit risk are illustrated in the table below:

| 2019 | Gross loans and advances to banks and customers £m | Other financial assets £m | Derivatives £m | Total exposure £m |
|---|---|---|---|---|
| Central and local government | 380 | 5,068 | - | 5,448 |
| Manufacturing | 14 | - | - | 14 |
| Construction | 70 | - | - | 70 |
| Finance | 10,048 | - | 36 | 10,084 |
| Service industries and business activities | 44 | - | - | 44 |
| Agriculture, forestry and fishing | 11 | - | - | 11 |
| Property | 2,283 | - | - | 2,283 |
| Individuals | 344 | - | - | 344 |
| Home mortgages | 2,612 | - | - | 2,612 |
| Other | 731 | 1 | - | 732 |
| | 16,537 | 5,069 | 36 | 21,642 |

| 2018 | Gross loans and advances to banks and customers £m | Other financial assets £m | Derivatives £m | Total exposure £m |
|---|---|---|---|---|
| Central and local government | 51 | 3,731 | - | 3,732 |
| Manufacturing | 13 | - | - | 13 |
| Construction | 53 | - | - | 53 |
| Finance | 9,442 | - | 26 | 9,463 |
| Service industries and business activities | 55 | - | - | 46 |
| Agriculture, forestry and fishing | 5 | - | - | 5 |
| Property | 2,303 | - | - | 2,215 |
| Individuals | 842 | - | - | 817 |
| Home mortgages | 2,317 | - | - | 2,137 |
| Other | 1,062 | - | - | 1,008 |
| | 16,143 | 3,731 | 26 | 19,900 |

Gross assets of £724m (2018: £9m) and gross liabilities of £724m (2018: £9m), are subject to netting arrangements. The asset balances included above consist of only Customer deposits and Loans and advances to banks and customers which have been offset with the full amount of the liability balances of £74m (2018: £9m) in accordance with the offsetting rules of IAS 32.

This section covers the credit risk profile of trading activities.

| | Reverse repos | | | Repos | | |
|---|---|---|---|---|---|---|
| 31-Dec-19 | Total £m | of which offsettable £m | Outside netting arrangements £m | Total £m | of which offsettable £m | Outside netting arrangements £m |
| Gross | 650 | 650 | - | 650 | 650 | - |
| IFRS offset | (650) | (650) | - | (650) | (650) | - |
| Carrying value | - | - | - | - | - | - |
| Securities collateral | 650 | - | - | 650 | - | - |

## 17. Risk management (continued)

### Credit risk continued

### Collateral and credit enhancement – Total

The table below summarises financial assets of modelled portfolios within the scope of the ECL framework as well as credit mitigation and credit enhancements.

| | Gross | Netting | | Maximum credit risk | | CREM by type | | | CREM coverage | | Exposure post CREM | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | exposure | and offset | ECL | Total | Stage 3 | Financial [1] | Property | Other [2] | Total | Stage 3 | Total | Stage 3 |
| 2019 | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| Financial assets | | | | | | | | | | | | |
| Cash and balances at central banks | 10,617 | - | - | 10,617 | - | - | - | - | - | - | 10,617 | - |
| Loans - amortised cost | 16,205 | 724 | 29 | 15,452 | 100 | 536 | 4,833 | 47 | 5,416 | 81 | 10,036 | 19 |
| Personal | 2,914 | - | 14 | 2,900 | 53 | - | 2,573 | - | 2,573 | 52 | 327 | 1 |
| Wholesale | 13,291 | 724 | 15 | 12,552 | 47 | 536 | 2,260 | 47 | 2,843 | 29 | 9,709 | 18 |
| Debt securities | 5,068 | - | - | 5,068 | - | - | - | - | - | - | 5,068 | - |
| Total financial assets | 31,890 | 724 | 29 | 31,137 | 100 | 536 | 4,833 | 47 | 5,416 | 81 | 25,721 | 19 |
| Contingent liabilities and commitments | | | | | | | | | | | | |
| Personal | 495 | - | - | 495 | - | - | - | - | - | - | 495 | - |
| Wholesale | 6,115 | - | 1 | 6,114 | 4 | 146 | 290 | 17 | 453 | 1 | 5,661 | 3 |
| Total off-balance sheet | 6,610 | - | 1 | 6,609 | 4 | 146 | 290 | 17 | 453 | 1 | 6,156 | 3 |
| Total exposure | 38,500 | 724 | 30 | 37,746 | 104 | 682 | 5,123 | 64 | 5,869 | 82 | 31,877 | 22 |
| 2018* | | | | | | | | | | | | |
| Financial assets | | | | | | | | | | | | |
| Cash and balances at central banks | 10,437 | - | - | 10,437 | - | - | - | - | - | - | 10,437 | - |
| Loans - amortised cost | 13,151 | 9 | 32 | 13,110 | 88 | 141 | 9,919 | 254 | 10,314 | 64 | 4,900 | 24 |
| Personal | 2,654 | - | 20 | 2,634 | 77 | - | 4,738 | - | 4,738 | 60 | - | 17 |
| Wholesale | 10,497 | 9 | 12 | 10,476 | 11 | 141 | 5,181 | 254 | 5,576 | 4 | 4,900 | 7 |
| Debt securities | 3,729 | - | - | 3,729 | - | - | - | - | - | - | 3,729 | - |
| Total financial assets | 27,317 | 9 | 32 | 27,276 | 88 | 141 | 9,919 | 254 | 10,314 | 64 | 19,066 | 24 |
| Contingent liabilities and commitments | | | | | | | | | | | | |
| Personal | 283 | - | - | 283 | - | - | - | - | - | - | 283 | - |
| Wholesale | 14,819 | - | - | 14,819 | - | 67 | 480 | 26 | 573 | - | 14,246 | - |
| Total off-balance sheet | 15,102 | - | - | 15,102 | - | 67 | 480 | 26 | 573 | - | 14,529 | - |
| Total exposure | 42,419 | 9 | 32 | 42,378 | 88 | 208 | 10,399 | 280 | 10,887 | 64 | 33,595 | 24 |

*2018 data has been restated for a change to presentation of unrecognised interest. Refer to Accounting policy 1, Other amendments to IFRS, for further details.
Notes:
(1) Includes cash and securities collateral.
(2) Includes guarantees

### 17. Risk management (continued)

#### Credit risk - Banking activities
#### Introduction
This section covers the credit risk profile of the Group's banking activities.

Financial instruments within the scope of IFRS 9 ECL
Refer to Note 8 for balance sheet analysis of financial assets that are classified as amortised cost (AC) or fair value through other comprehensive income (FVOCI), the starting point for IFRS 9 ECL assessment.

Financial assets

| | 2019<br>£m | 2018<br>£m |
|---|---|---|
| Balance sheet total gross AC/FVOCI | 31,167 | 27,288 |
| In scope of IFRS 9 ECL framework | 31,166 | 27,286 |
| % in scope | 99.99% | 99.99% |
| Loans - in scope | 15,481 | 13,110 |
| Stage 1 | 14,815 | 12,754 |
| Stage 2 | 545 | 262 |
| Stage 3 | 121 | 94 |
| Other financial assets - in scope | 15,685 | 14,176 |
| Stage 1 | 15,685 | 14,176 |
| Out of scope of IFRS 9 ECL framework | 1 | 2 |

#### Credit risk asset quality

The asset quality analysis presented below is based on the Company's internal asset quality ratings which have ranges for the probability of default, as set out below. Customers are assigned credit grades, based on various credit grading models that reflect the key drivers of default for the customer type. All credit grades across the Company map to both an asset quality scale, used for external financial reporting, and a master grading scale for wholesale exposures used for internal management reporting across portfolios.

The table that follows details the relationship between asset quality (AQ) bands and external ratings published by Standard & Poor's (S&P), for illustrative purposes only. This relationship is established by observing S&P's default study statistics, notably the one year default rates for each S&P rating grade. A degree of judgement is required to relate the probability of default ranges associated with the master grading scale to these default rates given that, for example, the S&P published default rates do not increase uniformly by grade and the historical default rate is nil for the highest rating categories.

| Internal asset quality band | Minimum % | Maximum % | Indicative S&P rating |
|---|---|---|---|
| AQ 1 | 0.000 | 0.034 | AAA to AA |
| AQ 2 | 0.034 | 0.048 | AA- |
| AQ 3 | 0.048 | 0.095 | A+ to A |
| AQ 4 | 0.095 | 0.381 | BBB+ to BBB- |
| AQ 5 | 0.381 | 1.076 | BB+ to BB |
| AQ 6 | 1.076 | 2.153 | BB- to B+ |
| AQ 7 | 2.153 | 6.089 | B+ to B |
| AQ 8 | 6.089 | 17.222 | B- to CCC+ |
| AQ 9 | 17.222 | 100.000 | CCC to C |
| AQ 10 | 100.000 | 100.000 | D |

The mapping to the S&P ratings is used by the Company as one of several benchmarks for its wholesale portfolios, depending on customer type and the purpose of the benchmark. The mapping is based on all issuer types rated by S&P. It should therefore be considered illustrative and does not, for instance, indicate that exposures reported against S&P ratings either have been or would be assigned those ratings if assessed by S&P. In addition, the relationship is not relevant for retail portfolios, smaller corporate exposures or specialist corporate segments given that S&P does not typically assign ratings to such entities.

## 17. Risk management (continued)

### Credit risk asset quality continued

### Portfolio summary - sector analysis

The table below summarises financial assets and off-balance sheet exposures gross of ECL, related ECL provisions, impairment and past due by sector and asset quality.

| 2019 | Personal £m | Wholesale £m | Total £m |
|---|---|---|---|
| Loans by geography | 2,914 | 12,567 | 15,481 |
| - *UK* | 2,914 | 8,789 | 11,703 |
| - *RoI* | - | 2 | 2 |
| - *Other Europe* | - | 2,437 | 2,437 |
| - *RoW* | - | 1,339 | 1,339 |
| Loans by asset quality | 2,914 | 12,567 | 15,481 |
| - *AQ1* | - | 5,548 | 5,548 |
| - *AQ2* | - | 1,566 | 1,566 |
| - *AQ3* | - | 1,401 | 1,401 |
| - *AQ4* | - | 2,311 | 2,311 |
| - *AQ5* | - | 814 | 814 |
| - *AQ6* | - | 533 | 533 |
| - *AQ7* | 2,849 | 311 | 3,160 |
| - *AQ8* | - | 22 | 22 |
| - *AQ9* | - | 5 | 5 |
| - *AQ10* | 65 | 56 | 121 |
| Loans by stage | 2,914 | 12,567 | 15,481 |
| - *Stage 1* | 2,799 | 12,016 | 14,815 |
| - *Stage 2* | 50 | 495 | 545 |
| - *Stage 3* | 65 | 56 | 121 |
| Loans - past due analysis | 2,914 | 12,567 | 15,481 |
| - *Not past due* | 2,826 | 12,549 | 15,375 |
| - *Past due 1-29 days* | 19 | 7 | 26 |
| - *Past due 30-89 days* | 8 | 1 | 9 |
| - *Past due 90-180 days* | 29 | 1 | 30 |
| - *Past due >180 days* | 32 | 9 | 41 |
| Loans - Stage 2 | 50 | 495 | 545 |
| - *Not past due* | 26 | 494 | 520 |
| - *Past due 1-29 days* | 18 | 1 | 19 |
| - *Past due 30-89 days* | 6 | - | 6 |
| ECL provisions by stage | 14 | 16 | 30 |
| - *Stage 1* | 1 | 2 | 3 |
| - *Stage 2* | 1 | 5 | 6 |
| - *Stage 3* | 12 | 9 | 21 |
| ECL provisions coverage (%) | 0.48 | 0.13 | 0.19 |
| - *Stage 1 (%)* | 0.04 | 0.02 | 0.02 |
| - *Stage 2 (%)* | 2.00 | 1.01 | 1.10 |
| - *Stage 3 (%)* | 18.46 | 16.07 | 17.36 |
| ECL charge | 1 | 1 | 2 |
| - *UK* | 1 | - | 1 |
| - *Other Europe* | - | 1 | 1 |
| ECL loss rate (%) | 0.03 | 0.01 | 0.01 |
| Amounts written-off | 5 | - | 5 |
| Other financial assets by asset quality | - | 15,685 | 15,685 |
| - AQ1 - AQ4 | - | 15,685 | 15,685 |
| Off-balance sheet | 495 | 6,115 | 6,610 |
| - *Loan commitments* | 495 | 5,896 | 6,391 |
| - *Financial guarantees* (1) | - | 219 | 219 |
| Off-balance sheet by asset quality | 495 | 6,115 | 6,610 |
| - *AQ1 - AQ4* | - | 5,582 | 5,582 |
| - *AQ5 - AQ8* | 495 | 528 | 1,023 |
| - *AQ9* | - | 1 | 1 |
| - *AQ10* | - | 4 | 4 |

Note:
(1) All Financial guarantees are considered as Stage 1.
(2) UK includes our exposures in Jersey, Guernsey, Isle of Man and Gibraltar.

## 17. Risk management (continued)

### Credit risk asset quality continued

| 2018* | Personal £m | Wholesale £m | Total £m |
|---|---|---|---|
| Loans by geography | 2,634 | 10,476 | 13,110 |
| *- UK* | 2,634 | 8,272 | 10,906 |
| *- RoI* | - | 2 | 2 |
| *- Other Europe* | - | 1,596 | 1,596 |
| *- RoW* | - | 606 | 606 |
| Loans by asset quality | 2,634 | 10,476 | 13,110 |
| *- AQ1* | - | 4,357 | 4,357 |
| *- AQ2* | - | 1,397 | 1,397 |
| *- AQ3* | - | 1,417 | 1,417 |
| *- AQ4* | - | 1,756 | 1,756 |
| *- AQ5* | - | 990 | 990 |
| *- AQ6* | - | 320 | 320 |
| *- AQ7* | 2,555 | 209 | 2,764 |
| *- AQ8* | - | 12 | 12 |
| *- AQ9* | - | 3 | 3 |
| *- AQ10* | 79 | 15 | 94 |
| Loans by stage | 2,634 | 10,476 | 13,110 |
| *- Stage 1* | 2,499 | 10,255 | 12,754 |
| *- Stage 2* | 56 | 206 | 262 |
| *- Stage 3* | 79 | 15 | 94 |
| Loans - past due analysis | 2,634 | 10,476 | 13,110 |
| *- Not past due* | 2,517 | 10,348 | 12,865 |
| *- Past due 1-29 days* | 22 | 116 | 138 |
| *- Past due 30-89 days* | 11 | 5 | 16 |
| *- Past due 90-180 days* | 44 | 7 | 51 |
| *- Past due >180 days* | 40 | - | 40 |
| Loans - Stage 2 | 56 | 206 | 262 |
| *- Not past due* | 25 | 201 | 226 |
| *- Past due 1-29 days* | 22 | - | 22 |
| *- Past due 30-89 days* | 9 | 5 | 14 |
| ECL provisions by stage | 20 | 12 | 32 |
| *- Stage 1* | 2 | 4 | 6 |
| *- Stage 2* | 1 | 2 | 3 |
| *- Stage 3* | 17 | 6 | 23 |
| ECL provisions coverage (%) | 0.76 | 0.11 | 0.24 |
| *- Stage 1 (%)* | 0.08 | 0.04 | 0.05 |
| *- Stage 2 (%)* | 1.79 | 0.97 | 1.15 |
| *- Stage 3 (%)* | 21.52 | 40.00 | 24.47 |
| ECL (releases)/charge | (2) | 1 | (1) |
| *- UK* | (2) | 1 | (1) |
| ECL loss rate (%) | (0.08) | 0.01 | (0.01) |
| Amounts written-off | 8 | - | 8 |
| Other financial assets by asset quality | - | 14,166 | 14,166 |
| *- AQ1 - AQ4* | - | 14,142 | 14,142 |
| *- AQ5 - AQ8* | - | 24 | 24 |
| Off-balance sheet | 283 | 14,819 | 15,102 |
| *- Loan commitments* | 283 | 14,381 | 14,664 |
| *- Financial guarantees* | - | 438 | 438 |
| Off-balance sheet by asset quality | 283 | 14,819 | 15,102 |
| *- AQ1 - AQ4* | - | 14,175 | 14,175 |
| *- AQ5 - AQ8* | 283 | 643 | 926 |
| *- AQ10* | - | 1 | 1 |

*2018 data has been restated for a change to presentation of unrecognised interest. Refer to Accounting policy 1, Other amendments to IFRS, for further details.

**17. Risk management (continued)**

**Non-traded market risk**

Definition

Non-traded market risk is the risk to the value of assets or liabilities outside the trading book, or the risk to income, that arises from changes in market prices such as interest rates, foreign exchange rates and equity prices, or from changes in managed rates.

Sources of risk

The key sources of non-traded market risk are interest rate risk and foreign exchange risk.

*Interest rate risk*

Non-traded interest rate risk (NTIRR) arises from the provision to customers of a range of banking products with differing interest rate characteristics. When aggregated, these products form portfolios of assets and liabilities with varying degrees of sensitivity to changes in market interest rates. Mismatches can give rise to volatility in net interest income as interest rates vary.

The Company has the benefit of a pool of stable, non and low interest-bearing liabilities, principally comprising equity and money transmission accounts. These balances are hedged, either by investing directly in longer-term fixed-rate assets (primarily fixed-rate mortgages or UK government Gilts), in order to provide a consistent and predictable revenue stream. In future, the Company may consider the use of interest rate swaps, which are generally booked as cash flow hedges of floating-rate assets.

*Foreign exchange risk*

Non-trading foreign exchange risk exposure arises principally due to investments in overseas operations. Movements in the exchange rates of the operational currency of the overseas investment will impact the balance sheet and the income statement unless the investment is financed by borrowings in the same currency.

All transactional (or non-structural) currency exposure risk is managed by Treasury and there remains an immaterial open position which is measured on a daily basis within set limits. The principal non-sterling currencies in which the Company has transactional currency exposure are the US dollar and the euro.

**Value-at-risk (VaR)**

VaR is a statistical estimate of the potential change in the market value of a portfolio (and, thus, the impact on the income statement) over a specified time horizon at a given confidence level.

The Company's standard VaR metrics – which assume a time horizon of one trading day and a confidence level of 99% – are based on interest rate repricing gaps at the reporting date. Daily rate moves are modelled using observations from the last 500 business days. These incorporate customer products plus associated funding and hedging transactions as well as non-financial assets and liabilities. Behavioural assumptions are applied as appropriate.

The non-traded interest rate risk VaR metrics for the Company's retail and commercial banking activities are included in the banking book VaR table presented below. The VaR captures the risk resulting from mismatches in the repricing dates of assets and liabilities.

It includes any mismatch between structural hedges and stable non and low interest-bearing liabilities such as equity and money transmission accounts as regards their interest rate repricing behavioural profile.

The Company manages market risk through VaR limits as well as stress testing, position and sensitivity limits. The table below shows one-day internal banking book VaR at a 99% confidence level.

| | 31 December 2019 £m | Maximum £m | Minimum £m | Average £m |
|---|---|---|---|---|
| Value-at-Risk | 0.08 | 0.16 | 0.06 | 0.09 |

| | 31 December 2018 £m | Maximum £m | Minimum £m | Average £m |
|---|---|---|---|---|
| Value-at-Risk | 0.08 | 0.18 | 0.07 | 0.10 |

**Liquidity risk**

Liquidity risk is the risk that the Company does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost. The Company performs daily liquidity monitoring to ensure compliance with limits set by its Board and by the regulators in the jurisdiction within which it operates. Quarterly reports are made to the Assets and Liabilities Committee and the Board covering Sterling and other currency liquidity.

The ultimate parent company, The Royal Bank of Scotland Group plc, is required by the Financial Conduct Authority to meet its Sterling obligations without recourse to the wholesale money market for a period of at least five business days. The Company manages its capital and liquidity, including drawing on support provided by the UK government and central banks in response to market conditions, in a responsible manner that continues to provide sufficient capital resources and liquidity for the Company to meet its obligations as they fall due.

Liquidity risk is monitored daily with performance reported to the Assets and Liabilities Committee regularly.

Financial assets have been reflected in the time band of the latest date on which they could be repaid unless earlier repayment can be demanded by the reporting entity; financial liabilities are included at the earliest date on which the counterparty can require repayment regardless of whether or not such early repayment results in a penalty.

If the repayment of a financial asset or liability is triggered by, or is subject to, specific criteria such as market price hurdles being reached, the asset is included in the latest date on which it can repay regardless of early repayment whereas the liability is included at the earliest possible date that the conditions could be fulfilled without considering the probability of the conditions being met. For example, if a structured note is automatically prepaid when an equity index exceeds a certain level, the cash outflow will be included in the less than three months period whatever the level of the index at the year end. As the repayment of assets and liabilities are linked, the repayment of assets in securitisations is shown on the earliest date that the asset can be prepaid as this is the basis used for liabilities.

### 17. Risk management (continued)

#### Contractual maturity

This table shows the residual maturity of financial instruments, based on contractual date of maturity. Hedging derivatives are included in the relevant maturity bands.

| | Banking activities | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 2019 | Less than 1 month £m | 1-3 months £m | 3-6 months £m | 6 months - 1 year £m | Subtotal £m | 1-3 years £m | 3-5 years £m | More than 5 years £m | Total £m |
| Cash and balances at central banks | 10,617 | - | - | - | 10,617 | - | - | - | 10,617 |
| Derivatives | 14 | 5 | 7 | 3 | 29 | 6 | 1 | - | 36 |
| Loans to banks | 1,337 | - | - | - | 1,337 | - | - | - | 1,337 |
| Loans to customers | 1,311 | 1,081 | 937 | 2,696 | 6,025 | 4,006 | 1,258 | 2,826 | 14,115 |
| Personal | 248 | 28 | 24 | 39 | 339 | 63 | 101 | 2,455 | 2,958 |
| Corporate | 232 | 225 | 130 | 565 | 1,152 | 1,160 | 842 | 348 | 3,502 |
| Financial institutions (excluding banks) | 831 | 828 | 783 | 2,092 | 4,534 | 2,783 | 315 | 23 | 7,655 |
| Other financial assets | 23 | 1,352 | 427 | 15 | 1,817 | 1,440 | 801 | 1,011 | 5,069 |
| Total financial assets | 13,302 | 2,438 | 1,371 | 2,714 | 19,825 | 5,452 | 2,060 | 3,837 | 31,174 |
| 2018 | | | | | | | | | |
| Total financial assets | 12,300 | 1,154 | 801 | 3,255 | 17,510 | 4,066 | 2,626 | 3,098 | 27,300 |
| Bank deposits | 14 | - | - | - | 14 | - | - | - | 14 |
| Customer deposits | 24,615 | 4,421 | 702 | 393 | 30,131 | 6 | - | - | 30,137 |
| Personal | 5,995 | 356 | 385 | 322 | 7,058 | 3 | - | - | 7,061 |
| Corporate | 5,151 | 1,361 | 18 | 60 | 6,590 | - | - | - | 6,590 |
| Financial institutions (excluding banks) | 13,469 | 2,704 | 299 | 11 | 16,483 | 3 | - | - | 16,486 |
| Derivatives | 12 | 5 | 6 | 4 | 27 | 8 | 3 | 18 | 56 |
| Total financial liabilities | 24,641 | 4,426 | 708 | 397 | 30,172 | 14 | 3 | 18 | 30,207 |
| 2018 | | | | | | | | | |
| Total financial liabilities | 22,212 | 3,270 | 396 | 144 | 26,022 | 9 | 2 | 6 | 26,039 |

#### Capital risk

The Company manages its capital to ensure that branches will be able to continue as a going concern while maximising the return to stakeholders through the optimisation of the debt and equity balance.

The capital structure of the Company consists of equity attributable to equity holders of the ultimate parent, comprising issued capital, reserves and retained earnings as disclosed in the Statement of Changes in Equity.

The Company has capital adequacy requirements imposed by the following regulators –
The Jersey Financial Services Commission (JFSC) – Lead regulator
Commission de Surveillance du Secteur Financier Prudential Regulation Authority

The Company is required to report its total capital ratio and Common Equity Tier 1 (CET1) capital ratio to the lead regulator on a periodic basis. The ratios are calculated as total capital to total risk-weighted assets, expressed as a percentage and CET1 capital to total risk-weighted assets, expressed as a percentage. The JFSC has established the Codes of Practice for Deposit-taking Business and includes that a registered person's total capital ratio minimum is 10% and CET1 capital ratio minimum is 8.5%.

##### Constituents of capital

The determination of what instruments and financial resources are eligible to be counted as capital is laid down in applicable regulation. Capital is categorised by applicable regulation under two tiers (1 and 2) according to the ability to absorb losses, degree of permanency and the ranking of absorbing losses.

There are three broad categories of capital across these two tiers:

- CET1 capital must be perpetual and capable of unrestricted and immediate use to cover risks or losses as soon as these occur. This includes ordinary shares issued and retained earnings. CET1 capital absorbs losses before other types of capital and any loss absorbing instruments.
- Additional Tier 1 (AT1) capital is the second form of loss absorbing capital and must be capable of absorbing losses on a going concern basis. These instruments are either written down or converted into CET1 capital when a pre-specified CET1 ratio is reached. Coupons on AT1 issuances are discretionary and may be cancelled at the discretion of the issuer at any time. AT1 capital must have a minimum maturity of five years.
- Tier 2 capital is the Company's supplementary capital and provides loss absorption on a gone concern basis. Tier 2 capital absorbs losses after Tier 1 capital. The Company does not hold any Tier 2 capital.

## 17. Risk management (continued)

### Capital risk continued

#### Key developments in 2019

- In June 2019, the Company brought AT1 capital of £300m onto its balance sheet.
- Over the year, the Company paid dividends of £762m to the parent company RBS International (Holdings) Limited.
- The Company's CET1 ratio decreased by 4.4 basis points to 19.2% at 31 December 2019. It reflects the RWA reduction as well as the lower equity base following the dividends paid during the year.
- The Company's Total Capital Ratio increased by 0.1 basis points to 23.7% at 31 December 2019. It reflects the RWA reduction a decrease in Core Equity driven by dividend and an increase in Additional Tier 1 equity.
- RWAs decreased by £0.8 billion to £6.6 billion at 31 December 2019, primarily related to a decrease in placements with intergroup counterparties offset with an increase in placements to central banks.

#### Risk governance, appetite and controls

The Assets and Liabilities Committee reviews the capital structure of the Company on a quarterly basis. As part of this review, the committee considers the cost of capital and the risks associated with each class of capital, along with considering compliance of regulatory requirements. Based on recommendations of the committee, the Company will balance its overall capital structure through the payment of dividends, new share issues and share buy-backs as well as the issue of new debt or the redemption of existing debt.

### Pension risk

#### Definition

Pension risk is the risk to the Company caused by its contractual or other liabilities to, or with respect to, its pension schemes (whether established for its employees or those of a related company or otherwise). It is also the risk that the Company will make payments or other contributions to, or with respect to, a pension scheme because of a moral obligation or because RBS Group considers that it needs to do so for some other reason.

#### Sources of risk

The Company has exposure to pension risk through its defined benefit pension schemes to the extent that the schemes' assets, together with future investment returns and additional future contributions, are insufficient to meet the liabilities as they fall due. In such circumstances, the Company could be obliged (or may choose) to make additional contributions to the schemes, or be required to hold additional capital to mitigate such risk.

The main source of pension risk for the Company is through its largest scheme, the International Pensions Trust (IPT). Further detail on the Company's pension obligations can be found in Note 4 on the accounts.

#### Key developments in 2019

- The 31 March 2018 technical provisions valuation of the IPT was completed during the year and under the terms of the agreement, the Company paid a contribution of £80m which, together with future investment returns, aims to remove the deficit on the trustee board's technical provisions basis.
- As part of the transfer of Isle of Man Bank Limited's (IOMBL) assets and liabilities to RBS International Limited (RBSI Limited) during the year, IOMBL's two defined benefit pension schemes (namely The Isle of Man Bank Pension Fund and The Isle of Man Bank Widows' and Orphans' Fund) were transferred to the Company's balance sheet.
- The RBSI section of the RBS Group Pension Fund underwent an initial valuation during the year, having been created on 1 November 2018 as part of RBS Group's work to address the impact of ring-fencing on its pension schemes. This valuation was carried out as at 31 December 2018 and revealed a surplus of £8m on the trustee board's technical provisions basis.

#### Risk governance, appetite and controls

The RBSI Pension Forum receives authority from the Company's Board and is responsible for taking decisions or making recommendations in relation to the financial, compliance, policy and operational structure of the Company's pension arrangements. Where authority is not delegated, the Forum makes recommendations to the Company's Chief Financial Officer or the Board, depending on the materiality of the issue. The Company's Board retains ultimate authority for decision making.

For general information on risk governance, appetite and controls in the Company, refer to page 37. Further information specific to pension risk relating to RBS Group, as a whole, is detailed in the pension risk section of the RBS Group ARA.

#### Risk monitoring and measurement

The RBSI Pension Forum formulates the Company view of pension risk and provides a governance framework for all the Company's pension schemes.

RBS Group calculates stochastic stresses on its material defined benefit pension schemes each year. These tests are used to satisfy the requests of regulatory bodies such as the Bank of England. The stress calculations also form the basis of the pension risk Pillar 2 charge in the Company ICAAP.

#### Risk mitigation

The trustee board of the IPT is solely responsible for the investment of scheme assets which are held separately from the assets of the Company. The trustee board has taken measures to mitigate risk including adopting a diversified investment strategy and investing in liability driven investments, so that changes in the value of the liabilities will be partially matched by changes in the asset values, thus reducing volatility of the scheme's funding position.

Further liability driven investment is to be added to the scheme's assets following the payment of an £80m contribution in December 2019.

In managing the assets of the IPT, the trustee board also takes account of, and gives consideration to, the ability of investment managers to effectively deal with environmental, social and ethical issues.

### Compliance & conduct risk

#### Definition

Compliance risk is the risk that the behaviour of the Company and its staff towards our customers fails to comply with laws, regulations, rules, standards and codes of conduct, leading to breaches of regulatory requirements, organisational standards or customer expectations resulting in legal or regulatory sanctions, material financial loss or reputational damage.

### 17. Risk management (continued)

Conduct risk is the risk that the conduct of the Company and its subsidiaries and its staff towards customers, or in the markets in which it operates, leads to unfair or inappropriate customer outcomes and results in reputational damage, financial loss or both.

#### Sources of risk
Compliance and conduct risks exist across all stages of the Company's relationships with its customers and arise from a variety of activities including product design, marketing and sales, complaint handling, staff training, and handling of confidential insider information. As set out in the consolidated accounts of RBS Group, certain members of staff are party to legal proceedings and are subject to investigation and other regulatory action in the UK, the US and other jurisdictions.

#### Key developments in 2019
- Policies were rationalised and simplified to support wider understanding and compliance.
- Targeted training was rolled out across the lines of defence to support framework embedding.
- Planning for LIBOR transition continued including an extended SONIA pilot and further industry engagement.
- Preparations continued for a number of Brexit outcomes.

#### Risk governance
The Company defines appropriate standards of compliance and conduct and ensures adherence to those standards through the risk management framework. Relevant compliance and conduct matters are escalated through Executive Risk Committee and Board Risk Committee.

#### Risk appetite
Risk appetite for compliance and conduct risks is set at Board level. Risk appetite statements articulate the levels of risk that legal entities, businesses and functions work within when pursuing their strategic objectives and business plans.

#### Risk controls
A range of controls is operated to ensure business delivers good customer outcomes and is conducted in accordance with legal and regulatory requirements. A suite of policies addressing compliance and conduct risks set appropriate standards across RBS Group. Examples of these include the Complaints Management Policy, Client Assets & Money Policy, and Product Lifecycle Policy as well as policies relating to customers in vulnerable situations, cross-border activities and market abuse. Continuous monitoring and targeted assurance is carried out as appropriate.

#### Risk monitoring and measurement
Compliance and conduct risks are measured and managed through continuous assessment and reporting to senior risk committees and at Board level. The compliance and conduct risk framework facilitates the consistent monitoring and measurement of compliance with laws and regulations and the delivery of consistently good customer outcomes.

#### Risk mitigation
Activity to mitigate the most-material compliance and conduct risks is carried out across RBS Group with specific areas of focus in the customer-facing businesses and subsidiaries such as the Company. Examples of mitigation include consideration of customer needs in business and product planning, targeted training, complaints management, as well as independent assurance activity. Internal policies help support a strong customer focus across RBS Group. Independent assessments of compliance with applicable regulations are also carried out at the Company level.

### Financial crime risk

#### Definition
Financial crime risk is the risk presented by criminal activity in the form of money laundering, terrorist financing, bribery and corruption, sanctions and tax evasion. It does not include fraud risk management.

#### Sources of risk
Financial crime risk may be presented if the Company's employees, customers or third parties undertake or facilitate financial crime, or if the Company's products or services are used to facilitate such crime. Financial crime risk is an inherent risk across all of the Company's lines of business.

#### Key developments in 2019
- Enhanced financial crime risk assessment processes were implemented to enable improved identification and mitigation of financial crime risks
- Financial crime policies were refreshed and updated to reflect changes to the regulatory environment and industry best practice.

#### Risk governance
The RBS Group Financial Crime Risk Executive Committee, which is chaired by the RBS Group Chief Financial Crime Risk Officer, is the principal financial crime risk management forum. The committee reviews and, where appropriate, escalates material financial crime risks and issues across RBS Group to the Executive Risk Committee and the Board Risk Committee.

#### Risk appetite
There is no appetite to operate in an environment where systems and controls do not enable the identification, assessment, monitoring, management and mitigation of financial crime risk. The Company's systems and controls must be comprehensive and proportionate to the nature, scale and complexity of its businesses. There is no tolerance to systematically or repeatedly breach relevant financial crime regulations and laws.

#### Risk controls
The Company operates a framework of preventative and detective controls designed to ensure the Company mitigates the risk that it could facilitate financial crime. These controls are supported by a suite of policies, procedures and detailed instructions to ensure they operate effectively.

#### Risk monitoring and measurement
Financial crime risks are identified and reported through continuous risk management and regular monthly reporting to the Company's senior risk committees and the Board. Quantitative and qualitative data is reviewed and assessed to measure whether financial crime risk is within the Company's risk appetite.

#### Risk mitigation
Through the financial crime framework, the Company employs relevant policies, systems, processes and controls to mitigate financial crime risk. This would include the use of dedicated screening and monitoring controls to identify people, organisations, transactions and behaviours which might require further investigation or other actions. The Company ensures that centralised expertise is available to detect and disrupt threats to the Company and its customers. Intelligence is shared with law enforcement, regulators and government bodies to strengthen national and international defences against those who would misuse the financial system for criminal motives.

## 17. Risk management (continued)

### Climate risk

Definition

Climate risk is the risk arising from the effects of, and exposure to, climate change. It includes those risks likely to affect customers as well as RBS Group's ability to achieve its strategic ambitions together with the impact of the global transition to a low-carbon economy.

Sources of risk

Physical risk describes the more immediate and tangible effects of global warming, including rising sea levels and the increased occurrence of extreme weather events such as extended droughts, flooding and storms. These may affect business models, asset values or adversely affect the creditworthiness of customers. Large scale extreme weather events have the potential to affect operational, credit, market and sovereign risk.

Transition risk relates to the longer-term impact of the move to a low carbon economy, which may affect RBS Group, its customers and the wider market.

RBS Group submitted a detailed plan to the Prudential Regulation Authority detailing how it intends to address expectations on how the financial risks from climate change will be governed, managed, assessed and reported.

Risk governance

The RBS Group Climate Change Working Group, established in 2018, meets on a quarterly basis. Reporting to the Chief Risk Officer, its remit is to coordinate RBS Group activity in response to climate-related regulation, helping to address risks through robust metrics and analysis as well as identify the potential opportunities climate change may bring. The Bank is represented in this working group.

### Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or external events. It arises from day-to-day operations and is relevant to every aspect of the organisation.

Operational risk appetite supports effective management of material operational risks. It expresses the level and types of operational risk the Company is willing to accept to achieve its strategic objectives and business plans.

Risk appetite for operational risk is set at Board level. Risk appetite statements articulate the levels of risk that legal entities, businesses and functions work within when pursuing their strategic objectives and business plans.

Risk and control assessments are used across all business areas and support functions to identify and assess material operational and conduct risks and key controls.

All risks and controls are mapped to RBS Group's Risk Directory. Risk assessments are refreshed at least annually to ensure they remain relevant and capture any emerging risks as well as ensuring risks are reassessed.

The process is designed to confirm that risks are effectively managed in line with risk appetite. Controls are tested on a regular basis to ensure they operate effectively to reduce identified risks.

Scenario analysis is used to assess how extreme but plausible operational risks will affect the Company. It provides a forward-looking basis for evaluating and managing operational risk exposures.

Operational resilience is managed and monitored through the risk and control assessments methodology. This is underpinned by setting, monitoring and testing tolerances for key business services. Progress continues on the response to regulatory expectations on operational resilience.

### Model risk

A variety of models are used as part of risk management processes and activities. To mitigate the risk that models are specified, implemented or used incorrectly, independent validation and regular reviews are carried out. Oversight is provided by an RBS Group model risk governance committee in accordance with relevant policies and procedures. For further information on model risk, refer RBS Group Annual Report and Accounts.

### Reputational risk

A reputational risk policy is in place to support the management of issues that could pose a threat to the bank's public image. A number of measures – including some also used in the management of operational, conduct and financial risks – are used to assess risk levels against risk appetite. Where a material reputational risk is presented, this is escalated to the RBS Group Reputational Risk Committee. For further information on reputational risk, refer RBS Group Annual Report and Accounts.

Risk Factors – Replacement of LIBOR and EURIBOR

The Bank may not manage risks associated with the replacement of LIBOR, EURIBOR and other benchmark rates effectively.

Central banks and regulators in major jurisdictions (most notably the U.K., the E.U., the U.S., Switzerland and Japan) have convened working groups to find, and implement the transition to, suitable replacements for IBOR based interest rates.

The FCA, which regulates LIBOR in the UK, has announced that it will not compel panel banks to contribute to LIBOR after 2021. The E.U. regulation on Benchmark interest rates imposed conditions under which only compliant benchmarks may be used in new contracts after 2021.

In the UK, the Sterling Overnight Index Average (SONIA) has been selected as the preferred near Risk Free Rate (RFR) for the sterling markets. This rate is based on the overnight interest rates in wholesale markets and can be compounded over a lending period, which allows a term structure to be built.

Following this decision, the Bank of England has decided that from Q4 2019 to the end of 2021 all LIBOR referenced loans should be transitioned to SONIA. Transition mechanisms have been established and market participants are now in the process of converting their LIBOR linked contracts into RFR contracts. The transition to RFR means that, in line with the transition provisions and to deal with the basis risk between the IBOR based benchmark rates and the RFRs, a spread had to be added to the RFR to maintain the economics of the contract. This is dependent on the tenor of the original IBOR based rate.

RBS Group is fully engaged in the IBOR replacement discussions in the key markets where it operates while it continues to implement plans to appropriately mitigate the risks associated with the expected discontinuation of certain unsecured IBOR referenced benchmark interest rates (IBOR's), including the London Interbank Offered Rate (LIBOR).

## 17. Risk management (continued)

To this extent, RBS Group on the Bank's behalf

- reviewed or is in the process of reviewing the fallback language for LIBOR linked instruments, most notably floating rate notes, capital instruments, LIBOR referenced syndicated loans, asset backed securities and Libor referenced bilateral loan arrangements in line with the recommendations of the ARRC, ISDA and IOSCO as well as with the requirements of the EU Benchmarks Regulation.
- has been actively engaged in the discussions which led to the transition relief being provided by the International Accounting Standards Board (IASB) in relation to hedge accounting under both IAS 39 – Financial instruments – Recognition and Measurement (IAS 39) and IFRS 9 – Financial Instruments (IFRS 9).
- continues to engage with regulators and standard setters in relation to the additional items for which relief is being considered most notably accounting for modifications of financial instruments.
- continues to liaise with regulators, standard setters, industry groups and customers on other relevant matters as the transition to risk free rates progresses.
- is in the process of adjusting its products, processes and information systems to deal with the expected effects of the discontinuation of LIBOR most notably the transition and calculation rules.

## 18. 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 2019. Although the Company 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 Company's expectation of future losses.

| | 2019<br>£m | 2018<br>£m |
|---|---|---|
| **Contingent liabilities:** | | |
| Guarantees | 196 | 418 |
| Other contingent liabilities | 23 | 20 |
| Total contingent liabilities | 219 | 438 |
| **Commitments:** | | |
| Facilities with central banks and other correspondents banks (1) | - | 6,750 |
| Undrawn formal standby facilities, credit lines and other commitments to lend | 6,391 | 7,914 |
| | 6,391 | 14,664 |

Note:
(1) Facilities with central banks and other correspondents banks represent the difference between the limit provided by these entities to the Company and the cash placed with them. In 2018 financial statement the balance included in the note was £6,750m, however in 2019 it was agreed not to disclose this balance as there is no obligation for the Company to utilise the full limit provided.

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 Company'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 Company's normal credit approval processes.

### Contingent liabilities

These include standby letters of credit, supporting customer debt issues, contingent liabilities relating to customer trading activities such as those arising from performance and customs bonds, warranties and indemnities and obligations to The Royal Bank of Scotland plc.

### Commitments

These are a loan commitment, the Company 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.

### Litigation

The Company is involved in litigation involving claims by and against it which arise in the ordinary course of business. The directors of the Company, after reviewing the claims pending and threatened against the Company, and taking into account the advice of the relevant legal advisers, are satisfied that the outcome of these claims are unlikely to have a material adverse effect on the net assets of the Company.

## 19. Analysis of changes in financing during the financial year

| | Share capital, share premium and paid-in equity | |
|---|---|---|
| | 2019<br>£m | 2018<br>£m |
| At 1 January | 102 | 102 |
| Issue of Additional Tier 1 capital notes | 300 | - |
| Net cash flows from financing | 300 | - |
| At 31 December | 402 | 102 |

## 20. Analysis of cash and cash equivalents

| | 2019 £m | 2018 £m |
|---|---|---|
| At 1 January | | |
| - cash | 10,437 | 479 |
| - cash equivalents | 3,375 | 68 |
| | 13,812 | 547 |
| Net cash (outflow)/inflow | (648) | 13,200 |
| Effect of exchange rate changes on cash and cash equivalents | (277) | 65 |
| At 31 December | 12,887 | 13,812 |
| Comprising: | | |
| Cash and balances at central banks | 10,617 | 10,437 |
| Amounts due from holding companies and fellow subsidiaries | 933 | 2,865 |
| Loans to banks - amortised cost | 1,337 | 510 |
| | 12,887 | 13,812 |

The Company is required by law or regulation to maintain balances with the Central banks which are excluded from Cash and cash equivalents. These are set out below.

| | 2019 £m | 2018 £m |
|---|---|---|
| Central Bank of Luxembourg | 58 | 53 |
| Bank of England | 8 | 5 |
| Total | 66 | 58 |

## 21. Related parties

The Company's immediate parent company is The Royal Bank of Scotland International (Holdings) Limited.

The Company's ultimate holding company, and the parent of the largest group into which the Company is consolidated into is The Royal Bank of Scotland Group plc.

### UK Government

The UK Government through HM Treasury is the ultimate controlling party of The Royal Bank of Scotland Group plc. Its shareholding is managed by UK Financial Investments Limited, a company it wholly-owns and as a result, the UK Government and UK Government controlled bodies are related parties of the Company.

### (a) Transactions with key management

For the purposes of IAS 24 'Related Party Disclosure', key management comprise directors of the Company and members of the Executive Committee Offshore. The following amounts are attributable, in aggregate, to key management:

| | 2019 £'000 | 2018 £'000 |
|---|---|---|
| Loans and advances to customers | 1,304 | 2,116 |
| Customer accounts | 756 | 276 |
| Interest received | 19 | 37 |
| Interest paid | 2 | 3 |

Key management have banking relationships with RBS Group entities which are entered into in the normal course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with other persons of a similar standing or, where applicable, with other employees. These transactions did not involve more than the normal risk of repayment or present other unfavourable features.

### 21. Related parties (continued)

### (b) Related party transactions

| | 2019<br>£'000 | 2018<br>£'000 |
|---|---|---|
| **Assets** | | |
| Loans and advances to banks: | | |
| RBS Group entities | 1,056 | 3,037 |
| **Liabilities** | | |
| Deposits by banks: | | |
| RBS Group entities | 279 | 2,282 |
| **Income** | | |
| Interest received: | | |
| RBS Group entities | 22 | 142 |
| **Expenses** | | |
| Interest paid: | | |
| RBS Group entities | 15 | 7 |

Operating expenses includes Inter-group cost recharges of £63m (2018: £52m) from RBS Group.

During the year loans and mortgages of £0.6bn and deposits of £1.6bn were transferred to RBSI Isle of Man Branch of the Bank from Isle of Man Bank Limited. A total dividend of £762m (2018: £470m) was paid to RBSIH and preference dividends of £10m was paid to RBSG.

Furthermore, loans of £0.6bn were transferred to RBSI from Natwest Market Plc in 2019.

### (c) Compensation of key management

The aggregate remuneration of directors and other members of key management during the year was as follows:

| | 2019<br>£'000 | 2018<br>£'000 |
|---|---|---|
| Short term benefits | 2,466 | 3,665 |
| Post employment benefits | 804 | - |
| Share-based payments | 846 | - |
| Long term benefits | 673 | 1,091 |
| | 4,789 | 4,756 |