The Royal Bank of Scotland Group

RBS Sustainability Briefing Document

Our financing of the energy sector

October 2010

Why this briefing?

Climate change and energy security now represent two of the biggest challenges to ensuring a safe, sustainable future for the world's inhabitants over the coming decades. The energy industry is the major source of man-made greenhouse gas emissions worldwide, predominantly through the burning of fossil fuels such as coal, oil and gas.

The aim of this briefing is to provide more information on the role RBS plays in lending to the energy sector. Because of the relevance of the energy sector to climate change, and the need for us to understand climate-related risks in our lending, we have conducted analysis that is allowing us to provide more information on the different types of electricity generation that our energy clients are involved in.

We intend this document to contribute to enhanced disclosure on our financing of the energy industry in the years to come. Due to client confidentiality, we are not able to disclose details of specific clients but we believe there is substantial scope to add further analysis of the role RBS plays in financing the energy industry and how we are working with our clients to understand and mitigate climate-related risks.

Key Points

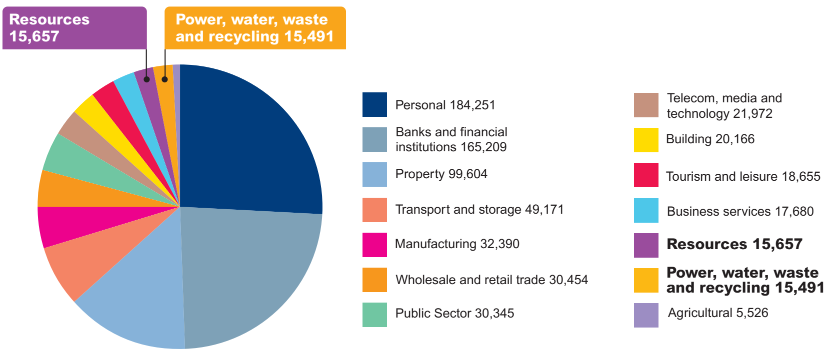
- Across the whole of RBS, approximately 3.6% of our lending (measured by total credit risk assets) is committed to the oil and gas and electricity sectors combined.
- Of this, 2.1% is to the oil and gas sector and 1.5% is to the electricity sector, which uses a mix of gas, nuclear, coal, oil and renewables.
- Since the UK Government's recapitalisation of RBS in 2008, our lending to the oil and gas and electricity sectors globally (measured by credit risk assets) has fallen by £9.1 billion and £11.2 billion respectively, and makes up a smaller proportion of our lending now than it did then.
- Our top 25 electricity clients are collectively generating electricity from gas and nuclear at a rate higher than the global average, and from coal at a rate much lower than the global average.
- Since 2006, we have provided more finance to wind power projects than any other type of energy project.
- Approximately 3% of our oil and gas lending is to companies who derive more than 10% of their income from oil sands operations.

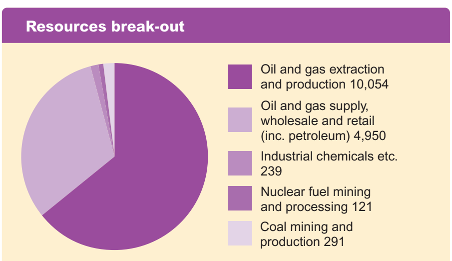
About RBS

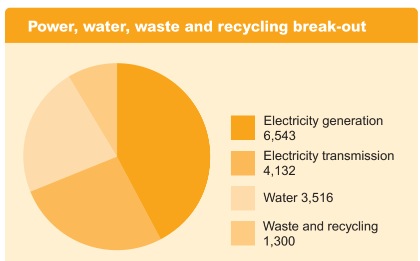
RBS is a large, international bank, providing a wide variety of banking services globally. As one of the top five largest lenders in the world[1], we provide banking services to almost all the major sectors of the global economy. The majority of our lending goes to personal customers, other banks, the property sector and governments. The chart below shows that approximately 2.1% of our total lending is to companies in the oil and gas sector, and 1.5% to the electricity sector - which is slightly less than their share of the global economy. The actual totals at June 2010 were £15 billion out to the oil and gas sector and £10.7 billion out to the electricity sectors, from a total lending portfolio of £706.9 billion.

Since the UK Government's recapitalisation of RBS in 2008, our lending to the energy sector has reduced significantly. In December 2008, shortly after the first phase of the UK Government's recapitalisation, our total lending to the oil and gas sector stood at £24.1 billion, with another £21.9 billion to the electricity sector. These sectors' share of our total lending were also higher then, accounting for 2.8% and 2.6% respectively of our total lending in December 2008.

Which sectors does RBS lend to? Total credit risk assets, June 2010 (£millions)







[1] Bloomberg data, September 2010.

Our lending

RBS is predominantly a deposit and lending bank: we take in money from deposits and other sources and lend it in the form of loans with the expectation that these will be paid back, usually over a pre-arranged period. For the energy sector, as with other sectors, we provide loans and other banking services (such as overdraft and money transmission services) but we do not usually 'invest' in energy companies or take ownership stakes in them. At any one time, the money we have lent out to the energy sector is continually being repaid and re-lent.

The majority of our lending to the energy sector is in the form of general corporate finance, which isn't usually tied to a specific use or project. When we provide general corporate finance, the client will make use of it in a variety of ways (for example by investing in their infrastructure or offices, purchasing other businesses or paying other costs). Much like the provision of a loan to a personal customer, a bank cannot under these circumstances stipulate how the loan is used, provided the client meets its requirements for the credit risks they represent. RBS has a range of policies and procedures in place to ensure we lend responsibly to customers.

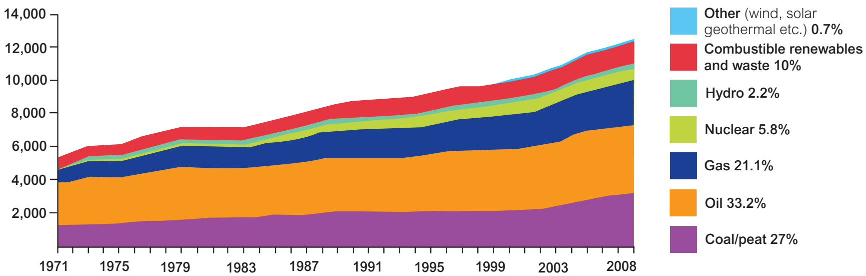
We also offer structured finance and associated advisory services for specific energy projects in the UK and US such as wind farms, gas pipelines and transmission grids. This type of lending is usually done as part of a group of banks who all lend to the same project. The repayment terms of the loan tend to be more closely defined, usually involving a source of cash-flow identified at the outset (e.g. earnings from the sale of electricity), and the repayment period is generally longer – up to 18 years in some cases.

The world's use of energy

Around the world, the demand for energy continues to rise as populations grow and living standards increase. Electricity is obtained from gas, coal, nuclear and renewables (hydro, biomass, wind, solar etc.), whereas oil tends to be used primarily as a transport fuel, heating fuel and in many industrial processes and products. Globally, total energy consumption is roughly twice what it was in 1970, with oil providing the largest proportion[2].

Global energy supply is still heavily dependent on fossil fuels: over 80% of total primary energy supply comes from coal/peat, oil and gas. The remainder is from nuclear power, hydro and combustible renewables (mostly wood and other biomass). Other forms of energy supply, such as wind, solar and geothermal have seen rapid growth in recent years but still make up a very small proportion of the world's primary energy supply. Within the electricity sector, however, their role is more significant.

Total primary energy supply by fuel[2]



Electricity and heat generation are the largest man-made source of greenhouse gas emissions globally, producing over 10Gt of CO_2 per year[3]. 75% of these emissions come from burning coal[4]. The Electricity sector is also the one that has seen the fastest growth in emissions in the last 40 years. Transport and industry are the next biggest sources of greenhouse gas emissions, with c.5Gt of CO_2 per year each.

[2] IEA, Key World Energy Statistics, 2010. (2008 figures)
[3] IPCC, Mitigation of Climate Change, Contribution of Working Group III to the Fourth Assessment Report, 2007. Figure 1.2.
[4] IEA, CO_2 from Fossil Fuel Combustion, Paris, 2009.

General corporate finance to electricity generators

Because general corporate finance is not tied to specific projects, we cannot associate it directly with specific forms of energy generation. We have, however, developed ways to better understand the nature of our energy clients' business.

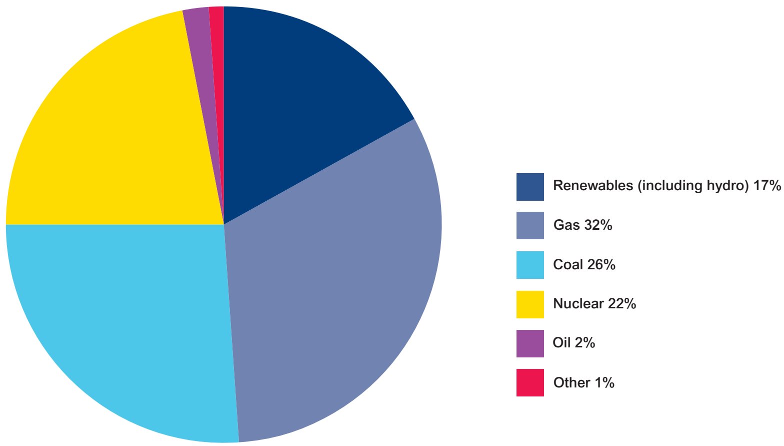
Our analysis identifies the generation mix (gas, coal, nuclear, renewables etc.) of our top 25 electricity sector clients and arrives at an average for each type of generation across this group of companies. We have compiled this data based on our clients' publicly reported information on the fuel mix of their installed generating capacity. The chart overleaf shows the current split between these different generation sources.

To help put this in context, we have compared these figures with the global average of electricity generation sources (see second chart, overleaf). This comparison shows that at present, our top 25 clients are on average using more gas and nuclear generation than the global average, slightly less renewables, and much less coal.

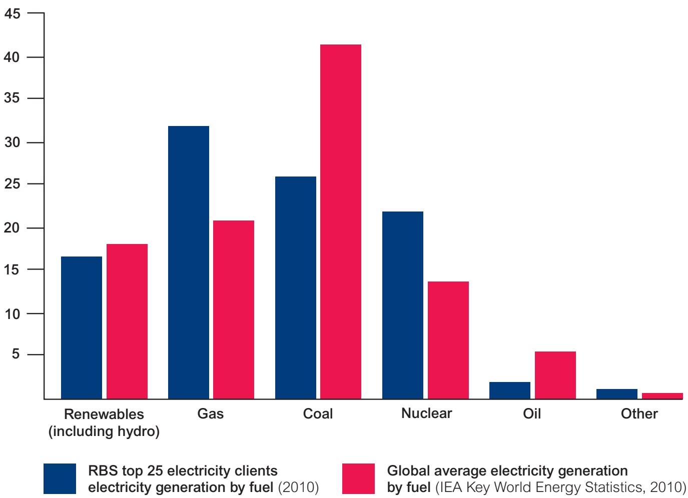
Coal is by far the most carbon intensive form of electricity generation, being responsible for c.75% of global CO_2 emissions from electricity generation[5]. Nuclear and gas are less carbon intensive, with renewables being the least. In the UK, approximately 6.2% of electricity is generated from renewables, which is less than the global average primarily because of the relative absence of very large-scale hydropower schemes.

[5] IEA, CO_2 from Fossil Fuel Combustion, Paris, 2009.

Electricity generation sources for our top 25 electricity clients (average, as at April 2010)



Electricity generation by fuel: RBS electricity clients vs. global average

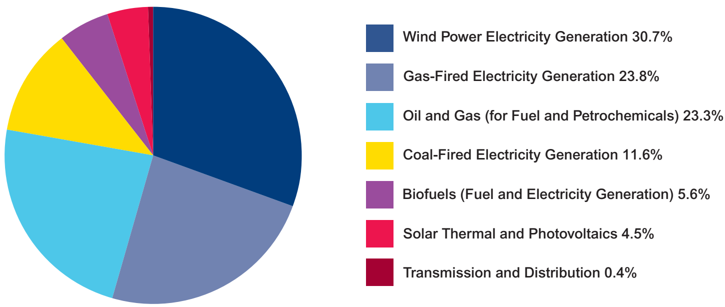


Lending to specific energy projects

In contrast with general corporate finance, some of our lending to the energy sector is in the form of structured finance where the client has identified a specific project that they need finance for. Typically, a group of banks will be involved in financing a project, each providing a share of the loan and taking a share of the risk.

We have categorised our lending to different types of energy projects from January 2006 to July 2010 (see chart below). Over this period, we have provided more finance to wind power projects than any other type of energy project, largely as a result of the significant growth this sector has experienced over recent years.

RBS Energy Related Structured Financing 2006-2010



Oil sands

Unconventional oil production, such as the oil sands developments in Alberta, Canada, have additional environmental impacts not normally associated with conventional oil extraction. These include additional CO_2 emissions from production and impacts on the local landscape, ecosystems and communities.

RBS has not provided any finance directly to an oil sands project for at least three years. We do however provide general corporate finance to a small number of companies who have some oil sands extraction and production operations. For most of these clients this forms a relatively small part of their overall business, but for others it forms a more significant part of their operations and income.

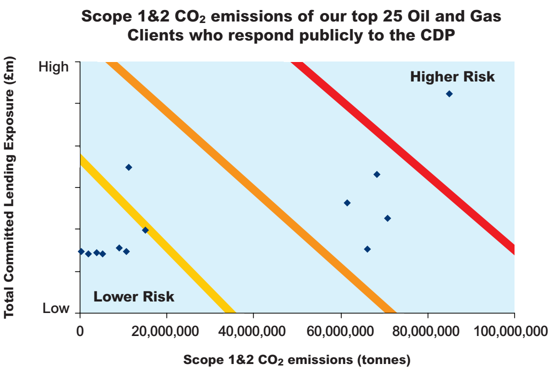
Overall, approximately 3% of our total oil and gas lending is to companies who derive more than 10% of their income from oil sands operations.

Client disclosure on carbon emissions

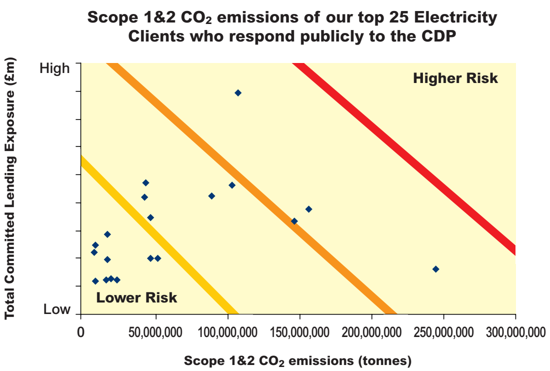
We support the objectives of the Carbon Disclosure Project (CDP), which is building an international database of companies' greenhouse gas emissions. We have identified which of our top 25 oil and gas and top 25 electricity clients respond publicly to the CDP on their scope 1 and 2 greenhouse gas emissions.

We have plotted these emissions against our total committed exposure to each client, which helps us to understand the carbon risks in our lending. The dots on the graphs below represent individual clients. Those which fall in the top right warrant greater attention either because we have a large lending exposure or because their reported greenhouse gas emissions are relatively high.

Oil and gas clients



Electricity clients



The future: Our commitments

Disclosure

We are committed to providing enhanced disclosure on our financing of the energy industry in the years to come. We will include further information on this in our annual Sustainability Report, as well as individual briefings such as this one. Due to client confidentiality, we will not be able to disclose details of specific clients, but we believe there is substantial scope to provide further analysis of the important role RBS plays in financing the energy industry and the ways we are addressing climate change-related risks.

The shape and focus of RBS as a business is likely to change over the coming years, which may mean that year-on-year comparisons are not always available or valid. However, we will continue to encourage our energy sector clients to disclose publicly to the Carbon Disclosure Project, and we will continue to do so as well. In 2010, RBS achieved the joint highest score globally among all the banks in the CDP.

Policies

In addition to our long-standing adoption of the Equator Principles for project finance, we are introducing revised environmental, social and ethical (ESE) risk policies governing our general lending to certain sectors, including the oil and gas sector. These policies will ensure that additional checks are made to ensure that clients have adequate procedures in place to mitigate adverse environmental and social impacts. In certain circumstances, these policies will also prevent the provision of finance where the environmental or social impacts are considered too high.

Renewables financing

We are committed to supporting the renewable energy industry through a variety of financing and advisory services. With 20 years' worth of expertise, we are continuing to develop ways to finance all sizes of installation, from micro-generation to large-scale wind farms. Our focus is on more mature technologies: as a major bank, it can be difficult to finance early-stage and developmental technologies due to the high credit risks involved.

The EU has a target of generating 20% of electricity supply from renewable sources by 2020 (with a UK target of 15%). Our top 25 electricity clients are already close to this figure and we are committed to helping to support the industry as a whole over the coming years. We believe that the regulatory and technological drivers are now in place within the energy industry to make this a realistic goal.

Collaboration

The most effective way of addressing the energy financing challenge is through cross-sector collaboration because this moves the whole banking sector forward as a whole. In this spirit, RBS will take a leading role in discussions to improve the way the Equator Principles for project finance incorporate climate change risks, as well as taking part in other initiatives to address climate change risks in energy sector financing. In September 2010, RBS will be supporting the Scottish Low Carbon Investment Conference in Edinburgh and in early 2011 we will be sponsoring the first ever Climate Week initiative: a programme of events showcasing the solutions to climate change and encouraging action in all parts of society.

More information on our overall approach to Sustainability, including our annual Sustainability Report, can be found on our website at **www.rbs.com/sustainability**

Note on data
This document uses data from a variety of sources which have not all been independently verified. In some cases, it makes use of data provided on a voluntary basis by other organisations that may involve some approximation. Whilst we have made every effort to ensure that data is current, we cannot guarantee its complete accuracy.

The Royal Bank of Scotland Group