

## Liquidity risk

The Group's liquidity policy is designed to ensure that it can at all times meet its obligations as they fall due.

Liquidity management within the Group focuses on overall balance sheet structure and the control, within prudent limits, of risk arising from the mismatch of maturities across the balance sheet and from exposure to undrawn commitments and other contingent obligations. The management of liquidity risk within the Group is undertaken within limits and other policy parameters set by GALCO. Compliance is monitored and coordinated by Group Treasury both in respect of internal policy and the regulatory requirements of the Financial Services Authority. In addition, all subsidiaries and branches

outside the UK ensure compliance with any local regulatory liquidity requirements and are subject to Group Treasury oversight.

## Diversification of funding sources

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

During 2007, the Group's funding sources remained well diversified by counterparty, instrument and maturity, both before and after the acquisition of ABN AMRO in October 2007.

Sources of funding	Including ABN AMRO		Excluding ABN AMRO		2006 £m	%	2005 £m	%
	2007 £m	%	2007 £m	%				
Customer accounts (excluding repos)								
Repayable on demand	346,074	24	225,908	26	197,771	28	172,853	27
Time deposits	201,375	14	140,630	17	122,467	17	121,260	19
Total customer accounts (excluding repos)	547,449	38	366,538	43	320,238	45	294,113	46
Debt securities in issue over one year remaining maturity	117,873	8	55,448	7	44,006	6	22,293	3
Subordinated liabilities	37,979	3	27,665	3	27,654	4	28,274	4
Owners' equity	53,038	4	53,177	6	40,227	6	35,435	6
Total customer accounts and long term funds	756,339	53	502,828	59	432,125	61	380,115	59
Repo agreements with customers	134,916	10	75,029	9	63,984	9	48,754	7
Repo agreements with banks	163,038	11	75,155	9	76,376	11	47,905	7
Total customer accounts, long term funds and collateralised borrowing	1,054,293	74	653,012	77	572,485	81	476,774	73
Debt securities in issue up to one year remaining maturity	155,742	11	89,189	10	41,957	5	68,127	11
Deposits by banks (excluding repos)	149,595	10	67,301	8	55,767	8	62,502	10
Short positions	73,501	5	47,058	5	43,809	6	37,427	6
<b>Total</b>	<b>1,433,131</b>	<b>100</b>	<b>856,560</b>	<b>100</b>	<b>714,018</b>	<b>100</b>	<b>644,830</b>	<b>100</b>

Customer accounts (excluding repos) and long term funds (term debt securities in issue of over one year remaining maturity and capital) continue to represent the core of the Group's funding. Excluding ABN AMRO, these core funds in total increased by £70.7 billion (16%) over the course of 2007 to represent 59% of total funding at 31 December 2007. The inclusion of ABN AMRO has added £253.5 billion to that total at 31 December 2007 to represent 53% of total funding in the enlarged balance sheet.

Customer accounts comprise a well diversified and stable source of funds from a wide range of retail, corporate and non-bank institutional customers. Excluding ABN AMRO, customer accounts grew by £46.3 billion (14%) to represent 43% of total funding at 31 December 2007. The inclusion of ABN AMRO has added £180.9 billion to that total at 31 December 2007, to represent 38% of total funding in the enlarged balance sheet.

Term debt securities in issue with an outstanding term of over one year increased £11.4 billion (26%) to represent 7% of the Group's funding at 31 December 2007 excluding ABN AMRO, reflecting the activity of the Group in raising term funds through its securitisation and Euro and US Medium Term Note programmes.

Including ABN AMRO, term debt issuance through its similar programmes has added £62.4 billion to that figure, to represent 8% of total funding in the enlarged balance sheet.

Capital (owners' equity and subordinated debt) increased by £13.0 billion (19%) to provide 9% of total funding at 31 December 2007.

Repo borrowing collateralised by a range of debt securities and other assets is undertaken with a range of corporate and institutional customers and banks. Excluding ABN AMRO, collateralised borrowing by repo increased by £9.8 billion (7%) to represent 18% of the Group's funding at 31 December 2007. Including ABN AMRO collateralised borrowing by repo has added £147.8 billion to that figure, to represent 21% of total funding in the enlarged balance sheet.

Short term wholesale funds (with up to one year residual maturity) are taken on an uncollateralised basis from a wide range of counterparties and debt investors, with the largest single depositor continuing to represent less than 1% of the Group's total funding.

Short positions in various securities are held primarily by RBS Greenwich Capital in the US, RBS Global Banking & Markets and by ABN AMRO Global Markets. Excluding ABN AMRO, the level of funding from short term unsecured debt issuance, bank deposits (excluding repos) and short positions has increased by £62.0 billion (44%) to represent 23% of total funding at 31 December 2007. Including ABN AMRO, such short-term wholesale borrowing has added £175.3 billion to that figure, to represent 26% of total funding in the enlarged balance sheet.

#### Net customer activity

Excluding ABN AMRO, net customer lending, excluding repos, rose by £14.7 billion (17%) over the course of 2007 as the growth in loans and advances to customers continued to exceed growth in customer accounts, thus increasing commensurately the reliance on wholesale market funding to support loan growth.

Including ABN AMRO, net customer lending, excluding repos, has added £43.5 billion, reducing the ratio of loans and advances to customer accounts to 126.6%.

	Including ABN AMRO 2007 £m	Excluding ABN AMRO 2007 £m	2006 £m	2005 £m
<b>Net customer activity</b>				
Loans and advances to customers (gross, excluding reverse repos)	693,331	468,942	407,918	372,223
Customer accounts (excluding repos)	547,449	366,538	320,238	294,113
Customer lending less customer accounts	145,882	102,404	87,680	78,110
Loans and advances to customers as a % of customer accounts (excluding repos)	126.6%	127.9%	127.4%	126.6%

#### Management of term structure

The Group evaluates on a regular basis its structural liquidity risk and applies a variety of balance sheet management and term funding strategies to maintain this risk within its normal policy parameters.

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

#### Stress testing

In August 2007, a systemic liquidity stress event was triggered by difficulties in the US sub-prime mortgage market which then spread more widely to the global asset-backed market and impacted adversely the overall supply and cost of funding and liquidity for other than very short-term maturities. RBS has managed its liquidity position through those market conditions, increased its liquidity cushion and remains able fully to meet its funding needs.

The Group performs stress tests to simulate how events may impact its funding and liquidity capabilities. Such tests inform the overall balance sheet structure and help define prudent limits for control of the risk arising from the mismatch of maturities across the balance sheet and from undrawn commitments and other contingent obligations. The nature of stress tests is kept under review in line with evolving market conditions.

Contingency funding plans are maintained to anticipate and respond to any approaching or actual material deterioration in market conditions. The Group remains confident that it can manage its liquidity requirements effectively under such circumstances.

#### Daily management

The primary focus of the daily management activity is to ensure access to sufficient liquidity to meet cash flow obligations within key time horizons, in particular out to one month ahead.

The short-term maturity structure of the Group's liabilities and assets is managed daily to ensure that all material or potential cash flow obligations, arising from undrawn commitments and other contingent obligations can be met. Potential sources include cash inflows from maturing assets, new borrowing or the sale of various debt securities held (after allowing for appropriate haircuts).

Short-term liquidity risk is generally managed on a consolidated basis with internal liquidity mismatch limits set for all subsidiaries and non-UK branches which have material local treasury activities, thereby assuring that the daily maintenance of the Group's overall liquidity risk position is not compromised. ABN AMRO, Citizens Financial Group and RBS Insurance manage liquidity locally, given different regulatory regimes, subject to review by Group Treasury. As integration of ABN AMRO's businesses within the Group proceeds, the liquidity risk policies, parameters and metrics used will be progressively aligned within a single framework.

## Business review continued

	Including ABN AMRO 2007 £m	Excluding ABN AMRO 2007 £m	2006 £m	2005 £m
<b>Net short-term wholesale market activity</b>				
Debt securities, listed held-for-trading equity shares, treasury and other eligible bills	328,352	174,724	135,775	129,440
Reverse repo agreements with banks and customers	318,298	146,675	117,060	90,691
Less: repos with banks and customers	(297,954)	(150,184)	(140,360)	(96,659)
Short positions	(73,501)	(47,058)	(43,809)	(37,427)
Insurance companies' debt securities held	(8,062)	(6,876)	(6,149)	(5,724)
Debt securities charged as security for liabilities	(29,709)	(8,911)	(8,560)	(9,578)
Net marketable assets	237,424	108,370	53,957	70,743
By remaining maturity up to one month:				
Deposits by banks (excluding repos)	112,181	38,470	36,089	35,153
Less: loans and advances to banks (gross, excluding reverse repos)	(25,609)	(21,763)	(21,136)	(16,381)
Debt securities in issue	66,289	28,814	19,924	20,577
Net wholesale liabilities due within one month	152,861	45,521	34,877	39,349
Net surplus of marketable assets over wholesale liabilities due within one month	84,563	62,849	19,080	31,394

Excluding ABN AMRO, the Group's net surplus of marketable assets over net short-term wholesale liabilities due within one month increased by £43.8 billion, reflecting actions taken by the Group to increase its liquidity cover in response to market conditions. Including ABN AMRO, the net surplus of marketable assets over net short-term wholesale liabilities due within one month was £84.6 billion.

### Sterling liquidity

Excluding ABN AMRO, over 36% of the Group's total assets are denominated in sterling, where the FSA requires the Group, on a consolidated basis, to maintain daily a minimum ratio of 100% between:

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

The FSA also sets an absolute minimum level for the stock of qualifying liquid assets that the Group is required to maintain each day. Internal processes ensure that the Group achieves or exceeds these minimum requirements at all times.

### Liquidity in non-sterling currencies

The Group also recognises the importance of non-sterling liquidity, which is managed daily within various limits. This takes into account the marketability, within a short period, of the wide range of debt securities held, if required to meet unexpected outflows.

The level of contingent risk from the potential drawing of undrawn or partially drawn commitments, back-up lines, standby lines and other similar facilities is also actively monitored and reflected in the measures of the Group's non-sterling liquidity risk. Particular attention is given to the US dollar commercial paper market and the propensity of the Group's bank and corporate counterparties who are active in raising funds from that market to switch to utilising facilities offered by the Group in the event of either counterparty specific difficulties or a significant widening of interest spreads generally in the commercial paper market.

The Group also provides liquidity back-up facilities to its own conduits and has small exposures to other selected conduits which take funding from the asset-backed commercial paper (“ABCP”) market. The short-term contingent liquidity risk in providing such backup facilities is mitigated by the spread of maturity dates of the commercial paper taken by the conduits. Limits sanctioned for such facilities totalled approximately £64 billion at 31 December 2007, of which £16 billion related to the RBS conduits and £48 billion to ABN AMRO conduits. The RBS conduits are multi-seller ABCP conduits rated at A1 or A1+/P1 levels. During the difficult market conditions since August 2007 the conduits were generally able to continue to issue rated CP albeit at generally shorter maturities and higher price levels than previously. There was an increased shortage of market liquidity, particularly in November and December, for longer dated issuance (i.e. over 1 month) as the year end approached. RBS and RBS Greenwich Capital Markets act as dealers to the conduits’ CP issuance programmes and have purchased CP in that capacity but such holdings have not generally been material. The majority of the ABN AMRO conduits are also rated A1 or A1+/P1 and they experienced similar trading conditions to the RBS conduits although they saw two small conduits draw liquidity. ABN AMRO Bank and ABN AMRO Corp act as dealers to the programmes and have held generally non material CP on inventory. The conduits are consolidated by the Group.

#### Developments in liquidity risk management regulation

During 2007, increased regulatory focus and the need for international coordination of liquidity risk management has been highlighted by external market conditions.

New liquidity regulation was also introduced by a number of local regulators, notably in the Republic of Ireland. The Group had no difficulties in meeting the new requirements.

Further regulatory developments are expected through 2008, including progress in harmonising liquidity requirements. Central Banks are also expected to continue to work to coordinate their liquidity supply arrangements in order to mitigate market conditions. The Group has been, and continues to be, actively involved in working with the various regulatory policy makers and central banks to assist the development of an appropriate future liquidity regime which takes into account both national considerations and the integrated cross-border approach to the management of liquidity risk within integrated banking groups such as the Group.

#### Market risk

Market risk is defined as the risk of loss resulting from adverse changes in risk factors such as interest rates, foreign currency and equity prices, together with related factors such as market volatilities.

The Group is exposed to market risk because of positions held in its trading portfolios as well as its non-trading business including the Group’s treasury operations.

There are two sources of market risk for the Group:

- **Trading:** the principal risk factors for the Group are interest rates, credit spreads, equity prices and foreign exchange.

The primary focus of the Group’s trading activities is client facilitation – providing products to the Group’s client base at competitive prices. The Group also undertakes: market making – quoting firm bid (buy) and offer (sell) prices with the intention of profiting from the spread between the quotes; arbitrage – entering into offsetting positions in different but closely related markets in order to profit from market imperfections; and proprietary activity – taking positions in financial instruments as principal in order to take advantage of anticipated market conditions.

Financial instruments held in the Group’s trading portfolios include, but are not limited to: debt securities, loans, deposits, equities, securities sale and repurchase agreements and derivative financial instruments (futures, forwards, swaps and options).

For a discussion of the Group’s accounting policies for, and information with respect to, its exposures to derivative financial instruments, see Accounting policies and Note 13 on the accounts.

- **Non-trading:** the principal market risks arising from the Group’s non-trading activities are interest rate risk, currency risk and equity risk.

Treasury activity and mismatches between the repricing of assets and liabilities in its retail and commercial banking operations account for most of the non-trading interest rate risk. Non-trading currency risk derives from the Group’s investments in overseas subsidiaries, associates and branches.

The Group’s strategic investment in Bank of China, venture capital portfolio and investments held by its general insurance business are the principal sources of non-trading equity price risk.

The Group’s portfolios of non-trading financial instruments mainly comprise loans (including finance leases), debt securities, equity shares, deposits, certificates of deposit and other debt securities issued, loan capital and derivatives. To reflect their distinct nature, the Group’s long-term assurance assets and liabilities attributable to policyholders have been excluded from these market risk disclosures.

#### Strategy and process

GEMC approves the Group’s trading book market risk appetite, expressed in value-at-risk (VaR) and stress testing limits. These limits are delegated to individual trading businesses within the Group. The Board, GEMC and GRC review monthly reports, which provide summary information on VaR, trading positions and stress tests.