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.

The market risk function is independent of the Group's trading businesses and is responsible for:

- effective application and compliance with the Group's Market Risk Policy Statement (MRPS), aligning the market risk taken by the Group with the risk limits set by GEMC;
- identification, measurement, monitoring, analysis and reporting of the market risk generated by the various businesses; and
- determination of appropriate policies and methodologies to measure and control market risk.

### Market risk measurement methodology

The Group uses a number of approaches to measure market risk in its trading and treasury portfolios. These approaches include:

#### (i) VaR

VaR is a technique that produces estimates of the potential negative change in the market value of a portfolio over a specified time horizon at given confidence levels. For internal risk management purposes, the Group's VaR assumes a time horizon of one trading day and a confidence level of 95%. The Group also calculates VaR at a confidence interval of 99% and a time horizon of ten trading days for the purposes of calculating trading book market risk capital.

The Group uses historical simulation models in computing VaR. This approach, in common with many other VaR models, assumes that risk factor changes observed in the past are a good estimate of those likely to occur in the future and is, therefore, limited by the relevance of the historical data used. The Group's method, however, does not make any assumption about the nature or type of underlying loss distribution. The Group typically uses the previous 500 trading days of market data.

The Group calculates both general market risk (i.e. the risk due to movement in general market benchmarks) and idiosyncratic market risk (i.e. the risk due to movements in the value of securities by reference to specific issuers) using its VaR models.

The Group's VaR should be interpreted in light of the limitations of the methodology used. These limitations include:

- Historical data may not provide the best estimate of the joint distribution of risk factor changes in the future and may fail to capture the risk of possible extreme adverse market movements which have not occurred in the historical window used in the calculations.

- VaR using a one-day time horizon does not fully capture the market risk of positions that cannot be liquidated or hedged within one day.

- VaR using a 95% confidence level does not reflect the extent of potential losses beyond that percentile.

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

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

| | 2007 | | | | 2006 | | | |
|---|---|---|---|---|---|---|---|---|
| Excluding ABN AMRO | Average £m | Period end £m | Maximum £m | Minimum £m | Average £m | Period end £m | Maximum £m | Minimum £m |
| Interest rate | 11.7 | 9.6 | 17.6 | 7.6 | 8.7 | 10.2 | 15.0 | 5.7 |
| Credit spread | 17.7 | 37.9 | 44.0 | 12.6 | 13.2 | 14.1 | 15.7 | 10.4 |
| Currency | 2.6 | 2.6 | 6.9 | 1.1 | 2.2 | 2.5 | 3.5 | 1.0 |
| Equity | 2.4 | 1.9 | 6.8 | 1.4 | 1.1 | 1.6 | 4.4 | 0.5 |
| Commodity | 0.2 | 0.1 | 1.6 | — | 0.2 | — | 1.1 | — |
| Diversification | | (12.4) | | | | (12.8) | | |
| Total trading VaR | 20.3 | 39.7 | 45.5 | 13.2 | 14.2 | 15.6 | 18.9 | 10.4 |

| | 2007 | | | |
|---|---|---|---|---|
| Including ABN AMRO | Average £m | Period end £m | Maximum £m | Minimum £m |
| Interest rate | 12.5 | 15.0 | 21.8 | 7.6 |
| Credit spread | 18.8 | 41.9 | 45.2 | 12.6 |
| Currency | 2.6 | 3.0 | 6.9 | 1.1 |
| Equity | 5.4 | 14.0 | 22.0 | 1.4 |
| Commodity | 0.2 | 0.5 | 1.6 | — |
| Diversification | | (28.7) | | |
| Total trading VaR | 21.6 | 45.7 | 50.1 | 13.2 |