

Pension obligation risk

The Group is also exposed to risk from its defined benefit pension schemes. The schemes' assets comprise investment portfolios which are held to meet projected liabilities to the scheme members. Risk arises from the schemes because returns from these portfolios may be less than expected and because there may be greater than expected increases in the estimated value of the schemes' liabilities. In these circumstances, the Group could be obliged, or may choose, to make additional contributions to the schemes.

Equity risk

Non-trading equity positions can result in changes in the Group's non-trading income and reserves arising from changes in equity prices/income. These movements may crystallise during the course of normal business activities or in stress market conditions.

There are several reasons for retaining equity positions in the Group's non-trading book, including achieving strategic objectives, expected capital gain and supporting venture capital transactions. These investments are carried at fair value with changes in fair value recorded in profit or loss, or in equity.

The types, nature and amounts of exchange-traded exposures, private equity exposures, and other exposures vary significantly. Such exposures may take the form of listed and unlisted equity shares, equity warrants and options, linked equity fund investments, private equity and venture capital investments, preference shares classified as equity and capital stock in the Federal Home Loans Bank and the Federal Reserve Bank.

Insurance risk

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

Effectively, an insurance contract transfers risk from the policyholder to the insurer, whereby, in return for a premium paid, the insurer indemnifies the policyholder on the occurrence of specified events. Insurance risk arises through fluctuations in the timing, frequency and/or severity of insured events, relative to the expectations at the time of underwriting. Insurance risk is managed in four distinct ways:

- Underwriting and pricing risk
- Claims management risk
- Reinsurance risk
- Reserving risk

Overall, insurance risk is predictable, supported by large volumes of data over time. Uncertainty does exist, especially around predictions, for example, variations in weather. Risk is minimised through the application of documented risk policies, coupled with governance frameworks.

The specific characteristics of each of the risks highlighted above are as follows:

Underwriting and pricing risk: the Group manages underwriting and pricing risk through a wide range of processes which include:

- Underwriting guidelines that detail the class, nature and type of business that may be accepted;
- Pricing policies which are set by senior management;
- Centralised control of policy wordings and any subsequent changes.

Claims management risk: arises if claims are handled or paid inappropriately. Claims are managed using a range of IT system controls and manual processes conducted by experienced staff. These, together with a range of detailed policies and procedures, ensure that claims are handled in a timely, appropriate and accurate manner. The processes include controls to avoid claims staff handling or paying claims beyond their level of authority, as well as controls to avoid paying invalid claims. Loss adjusters are used to handle certain claims to conclusion.

Reinsurance risk: the following types of reinsurance are used to protect against the impact of major catastrophic events or unforeseen volumes of (or adverse trends in) large individual claims and to transfer risk that is outside the Group's current risk appetite. Reinsurance of risks above the Group's risk appetite is only effective if the reinsurance premium payable makes economic sense and the counterparty is financially secure. Before entering a contract with a new reinsurer, it must satisfy the Credit Risk Approval process that uses information derived internally and from security ratings agencies. Acceptable reinsurers are rated at A- or better unless specifically authorised by the RBS Insurance Group Board.

- Excess of loss 'per individual risk' reinsurance to protect against significantly large individual losses.
- Excess of loss catastrophic 'event' reinsurance to protect against major events, for example, windstorms or floods.
- Quota share reinsurance to protect against unforeseen adverse trends, where the reinsurer takes an agreed percentage of premiums and claims.

Other forms of reinsurance may also be utilised, subject to approval by senior management.

Reserving risk: arises when reserves are assessed incorrectly, so that insufficient funds are retained to pay (or handle) claims as they fall due either for claims which have already occurred in relation to the claims reserves (including claims handling expense reserves) or will occur in future periods of insurance

(in relation to the premium reserves). The Group holds undiscounted claims reserves (including reserves to cover claims which have been incurred but not reported (IBNR reserves)) for all classes at a sufficient level to meet all liabilities as they fall due, having regard to actuarial estimates and the volatility observed and expected in the claims in each class. Group policy ensures that the net unearned premium reserves are adequate to meet the expected cost of claims and associated expenses in relation to the exposure after the balance sheet date. To the extent that the unearned premium reserves, net of reinsurance and deferred acquisition costs are inadequate, a liability adequacy provision will be held.

The Group's policy is to hold appropriate levels of provisions, typically in excess of the actuarial best estimate, for the major classes of business.

Frequency and severity of specific risks and sources of uncertainty

The Group's focus in its insurance operation is on high volume and relatively straightforward products, for example home and motor. This facilitates the generation of comprehensive underwriting and claims data, which are used to accurately price and monitor the risks accepted. This attention to data analysis is reinforced by tight controls on costs and claims handling procedures.

Most general insurance contracts are written on an annual basis, which means that the Group's liability extends for a twelve month period, after which the Group is entitled to decline or renew or can impose renewal terms by amending the premium, terms and/or conditions.

Uncertainty regarding possible frequency and severity of claims arise as follows:

a) **Motor insurance contracts (private and commercial):** claims experience varies, but the principal factors include age, gender and driving experience, together with the type of vehicle and location.

b) **Property insurance contracts (residential and commercial):** short-term uncertainty is mainly driven by weather conditions. Over a longer period, the strength of the economy is also a factor.

c) **Other commercial insurance contracts:** claims may arise from business interruption and loss arising from the negligence of the insured (liability insurance). Business interruption losses come from the loss of income, revenue and/or profit as a result of property damage claims. Liability insurance includes employers liability and public/products liability.

Fluctuations in the social, economic and legislative climate are a source of uncertainty in the Group's general liability account, and in particular court judgements and legislation, significant events (for example terrorist attacks), any emerging new heads of damage and types of claim that are not envisaged when the policy is written.

Life business

The three regulated life companies of the Group, National Westminster Life Assurance Limited, Royal Scottish Assurance plc and Direct Line Life Insurance Company Limited, are required to meet minimum capital requirements at all times under the Financial Service Authority's Prudential Sourcebook.

The capital resources covering the regulatory requirement are not transferable to other areas of the Group. To ensure that the capital requirement is satisfied at all times, each company holds a voluntary buffer above the regulatory minimum.

The Group is not exposed to price, currency, credit, or interest risk on unit linked life contracts but it is exposed to variation in management fees. A decrease of 10% in the value of the assets would reduce the asset management fees by £2 million per annum (2006 – £5 million). The Group also writes insurance contracts with minimum guaranteed death benefits that expose it to the risk that declines in the value of underlying investments may increase the Group's net exposure to death risk.

Operational risk

Operational risks are inherent in the Group's business. Operational risk losses occur as the result of fraud, human error, missing or inadequately designed processes, failed systems, damage to physical assets, improper behaviour or from external events.

To ensure appropriate responsibility is allocated for the management, reporting and escalation of operational risk, the Group operates a three lines of defence model which outlines principles for the roles, responsibilities and accountabilities for operational risk management:

- The first line of defence is the business line management. This is where the primary responsibility resides for the identification, management and mitigation of the risks associated with the products and processes of the business. This accountability includes regular testing and certification of the adequacy and effectiveness of controls and compliance with Group Policies including the Group's Operational Risk Policy and Principles ("ORPP").
- The second line of defence is the Operational Risk community. The Group Operational Risk department is responsible for the design and ownership of the ORPP. The ORPP provides the principles and minimum standards for delivering effective operational risk management. It incorporates key processes including risk and control assessment, scenario analysis, loss data collection, new product approval process, key risk indicators, notifiable events process, and the self certification process. Implementation of the ORPP is facilitated and overseen by Divisional Operational Risk teams who provide expert support and advice as well as oversight and challenge to business line management.