

(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.

- The third line of defence is audit. Group Internal Audit is responsible for assessing compliance with the ORPP and for providing independent evaluation of the adequacy and effectiveness of the risk and control framework.

Basel II introduces for the first time, a specific capital charge for operational risk. From launch in 2008, the Group will initially apply the Standardised Approach.

Regulatory risk and supervision

The approach to regulatory risk has three distinct elements:

- Review of potential changes in regulation to ensure the Group addresses the risks arising from such changes and implement them appropriately.
- Monitoring of compliance with existing rules and regulations and mitigating the consequences of any inadvertent non-compliance.
- Management of effective relationships with regulators to ensure open two-way communication.

The Group and its subsidiaries are fully engaged with regulatory authorities in all the jurisdictions in which they operate, in response to regulators' on-going supervisory requirements.

Under a Group-wide framework of high-level policies, regulatory risk is managed by developing, maintaining and implementing local policies and systems to ensure effective compliance. The Group's operating processes are designed so as to meet all regulatory and legal requirements in all jurisdictions that the Group operates in.

The Group works with domestic and international trade associations, and proactively engages with regulators, especially the UK Financial Services Authority (FSA), as well as with other influential stakeholders such as the Basel Committee, the Committee of European Banking Supervisors and the EU Commission, to gain an appropriate understanding of planned changes and to contribute to regulatory policy formulation.

Following the acquisition of ABN AMRO, the Group operates in over 50 countries.

In the normal course of business the Group and its subsidiaries co-operate with regulatory authorities in various jurisdictions in their enquiries or investigations into alleged or possible breaches of regulations.

The Group has co-operated fully with various regulatory reviews of the operation of retail banking and consumer credit industries in the UK and elsewhere.

These include the reviews by the Competition Commission and the FSA into payment protection insurance, the OFT's reviews of undertakings given following the Competition Commission inquiry in 2002 into the provision of banking services to SMEs. The OFT is also inquiring into credit and debit card interchange fees and has decided to undertake a fact find into unauthorised overdraft fees. In the EU, the European Commission is inquiring into MasterCard cross border interchange fees and has announced that its inquiry into retail banking has identified barriers to competition in certain areas of retail banking, payment systems and cards.

As previously disclosed by ABN AMRO, the United States Department of Justice has been conducting a criminal investigation into ABN AMRO's dollar clearing activities, Office of Foreign Assets Control compliance procedures and other Bank Secrecy Act compliance matters. ABN AMRO has cooperated and continues to cooperate fully with the investigation. Prior to the acquisition by the Group, ABN AMRO had reached an agreement in principle with the Department of Justice that would resolve all presently known aspects of the ongoing investigation by way of a Deferred Prosecution Agreement in return for a settlement payment by ABN AMRO of US\$500 million (which amount was accrued by ABN AMRO in its interim financial statements for the six months ended 30 June 2007). Negotiations are continuing to enable a written agreement to be concluded.

Certain of the Group's subsidiaries have received requests for information from various U.S. governmental agencies and self-regulatory organisations including in connection with sub-prime mortgages and securitisations, collateralised debt obligations and synthetic products related to sub-prime mortgages. The Group and its subsidiaries are cooperating with these various requests for information and investigations.

The outcome of these reviews is outside the Group's control and it is not possible to predict the effect, if any, on the Group's operations of future changes in regulatory actions and policies.