

Report of the skilled person on the proposed ring-fencing transfer scheme to transfer business from National Westminster Bank Plc (“NatWest Bank”) to NatWest Markets Plc (“NatWest Markets”)

Prepared by Oliver Grundy

11 May 2018

Important – Your attention is drawn to the limitations under which this report has been prepared as set out in Section 1.6

Contents

| | | |
|----|---|-----|
| 1 | Introduction | 3 |
| 2 | Conclusion | 12 |
| 3 | Overview and purpose of the Scheme | 13 |
| 4 | My role as the skilled person | 20 |
| 5 | Effect on Transferring Counterparties | 22 |
| 6 | Effect on other Stakeholders | 58 |
| 7 | Financial considerations | 62 |
| 8 | Governance and risk management considerations | 69 |
| 9 | Operational considerations | 72 |
| 10 | Resolvability considerations | 75 |
| 11 | Tax considerations | 78 |
| 12 | Communications | 81 |
| | Appendix 1 - Glossary | 88 |
| | Appendix 2 - Company Background | 97 |
| | Appendix 3 - Ring-fencing timeline | 99 |
| | Appendix 4 - Sources of information | 100 |

1 Introduction

1.1 The skilled person

In order to aid banking groups which are restructuring their businesses to comply with the ring-fencing requirements, a new type of statutory transfer scheme called a ring-fencing transfer scheme ("RFTS") has been introduced under Part VII of the Financial Services and Markets Act 2000.

When a RFTS is submitted to the Court for approval, it has to be accompanied by a report (the "Scheme Report") from an independent skilled person. This is a requirement of Section 109A of the Financial Services and Markets Act 2000 ("FSMA") and the Scheme Report must be made in a form approved by the Prudential Regulation Authority ("PRA") having consulted the Financial Conduct Authority ("FCA"), together the "Regulators".

I have been appointed as the skilled person to provide the required report on the ring-fencing transfer scheme for The Royal Bank of Scotland Group plc ("RBSG plc") and its subsidiaries (together "RBS" or "RBS Group") for the transfer of the customer derivative business from National Westminster Bank Plc ("NatWest Bank") to NatWest Markets Plc ("NatWest Markets") - (the "Scheme"). NatWest Markets Plc was formerly known as The Royal Bank of Scotland plc. The companies involved in this ring-fencing transfer scheme proposed by the RBS Group (the "Scheme Companies") are entities within the RBS Group.

I have been appointed as the skilled person for the Scheme (the "Skilled Person") jointly by RBSG plc, NatWest Bank and NatWest Markets (together, the "Companies") and my costs have been borne by RBS. My appointment has been approved by the PRA, having consulted with the FCA.

I am a Fellow of The Institute of Chartered Accountants in England and Wales ("ICAEW"), having qualified in 1985. I have been an audit partner for 25 years at Deloitte LLP ("Deloitte"), and was the Partner in Charge of the UK Banking & Securities Audit Group of Deloitte for ten years. I have carried out a wide range of advisory work and have been appointed as an expert under Section 166 of FSMA and as a Reporting Accountant to predecessor regulatory bodies. I am a member of the Council of the ICAEW (appointed 2015) and also sit on the ICAEW Risk and Regulation Committee (appointed 2015). Previous appointments also include being a member of the ICAEW Appeal Committee (2013 to 2015) and the ICAEW Disciplinary Committee and Tribunal Chairman (2007 to 2013).

1.2 Independence

Neither I, nor my immediate family hold any deposits, credit or loan agreements, mortgages, shareholdings or any other financial interests with NatWest Bank or any member of the RBS Group. I have not advised the RBS Group on any significant project in the past which I believe would affect the subject matter of the Scheme Report.

From 2000 to 2015, Deloitte acted as auditor to the RBS Group. Ernst & Young LLP have been the auditor for the RBS Group for the years ended 31 December 2016 and 2017.

Deloitte does, and will continue to, provide a range of advisory and consulting services to the RBS Group. In respect of potential services and business relationships, Deloitte has well established firm-wide systems and controls for identifying those services and relationships that may fall within, or close to, the perimeter of the subject matter of my review of the Scheme as the skilled person. Such potential services and relationships are and have been notified to me to consider; this consideration will include assessing whether effective safeguards exist to mitigate any actual or perceived threat to an acceptable level. Where threats cannot be mitigated to an acceptable level, or no effective safeguard exists, the service or relationship has not and will not proceed.

I note that I was the skilled person for another RBS ring-fencing transfer scheme (the "First Scheme"), which was announced on the 21 November 2017 and approved by the Court of Session, the supreme civil court of Scotland (the "Court") on 22 March 2018.

I do not believe that any of these assignments compromise my independence, create a conflict of interest, or compromise my ability to report on the proposed Scheme.

Deloitte has not acted for the RBS Group in developing any aspects of the Scheme, and has not carried out any of the calculations or the development of any of the underlying financial models connected with the Scheme.

1.3 Regulatory and professional guidance

The ICAEW has issued technical releases which apply to work undertaken by skilled persons. I have prepared this Scheme Report with the intention that it should meet the requirements of ICAEW Technical Release for Section 166 FSMA Skilled Person's Reports – TECH 15/14 FSF, specifically in relation to 'Review and Recommend' types of report. I believe that it does so in all material respects and I have applied all of the principles outlined in ICAEW TECH 15/14 in reaching the opinions stated in this Scheme Report.

In preparing this Scheme Report, I have also considered the PRA Statement of Policy "The implementation of ring-fencing: the PRA's approach to ring-fencing transfer schemes" published in March 2016" (the "PRA Statement of Policy") and the FCA Finalised Guidance 16/1 "Guidance on the FCA's approach to the implementation of ring-fencing and ring-fencing transfer schemes" published in March 2016 (the "FCA Guidance").

1.4 The Scope of my Scheme Report

1.4.1 Overview

The Scheme will be submitted to the Court, for sanction under Section 111 of FSMA. If approved, it is expected that the Scheme will become operative and take effect on 13 August 2018 (the "Effective Date"). This Scheme Report and any supplementary report (my "Supplementary Report" and, together with my Scheme Report, my "Scheme Reports") will be presented to the Court and the Court will consider the contents of these Scheme Reports in deciding whether to sanction the Scheme. This Scheme Report will be presented to the Court at the first hearing ("First Hearing") and any supplementary report will be presented to the Court at the hearing to decide whether to sanction the Scheme ("Final Hearing").

1.4.2 The Statutory Question

The legislation requires that the Scheme Report addresses the statutory question (the "Statutory Question") of:

- (a) whether persons other than the transferor concerned are likely to be adversely affected by the scheme; and
- (b) if so, whether the adverse effect is likely to be greater than is reasonably necessary in order to achieve whichever of the purposes mentioned in Section 106B(3) of FSMA is relevant.

The purposes in Section 106B(3) of FSMA are:

- (a) enabling a UK authorised person to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions;
- (b) enabling the transferee to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions;

- (c) making provision in connection with the implementation of the proposals that would involve a body corporate whose group includes the body corporate to whose business the scheme relates becoming a ring-fenced body while one or more other members of its group are not ring-fenced bodies; and
- (d) making provision in connection with the implementation of proposals that would involve a body corporate whose group includes the transferee becoming a ring-fenced body while one or more members of the transferee's group are not ring-fenced bodies.

In relation to this Scheme, the transferor is NatWest Bank, the transferee is NatWest Markets (together the "Scheme Companies") and the relevant purpose is Section 106B(3)(a) of FSMA i.e. enabling a UK authorised person to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions.

1.4.3 My approach to answering the Statutory Question

I have answered the Statutory Question by considering effects of the Scheme on customers, counterparties and other affected persons (together the "Stakeholders"). Effects of the Scheme can be both positive and negative. Although I have considered all effects identified, I have only considered part (b) of the Statutory Question where I believe a negative effect is "material" having taken into account the size and nature of the effect, the likelihood of occurrence and whether there are any mitigating actions being taken to reduce the negative effect. My assessment of effects is qualitative in nature and dependent on particular circumstances although my conclusions have been based on consideration of these factors:

- **Factor A – the size and nature of effect.** Effects of the Scheme can vary in size and nature and I have considered whether each negative effect will be material to any group of Stakeholders affected. What is "material" depends on the matter being considered and the particular circumstances. I have made my assessment from the perspective of any group of Stakeholders affected and the ability of the various types of Stakeholders to bear or mitigate negative effects. For example, if a negative effect of the Scheme is that certain counterparties each have to perform a straightforward additional administrative task, I may regard this as simply an inconvenience rather than an adverse effect in relation to the Statutory Question. If however, the Scheme results in a negative effect such as a financial penalty for a Stakeholder group, I may consider this to be an adverse effect in relation to the Statutory Question. As my assessment is made from the perspective of the Stakeholder, my conclusion may be different depending on the composition of the Stakeholder group. Therefore my conclusion may be dependent on whether those affected are, for example, small businesses, where I may conclude that a negative effect is material as opposed to a situation where the only group of Stakeholders are large financial institutions where, depending on facts and circumstances, I may conclude that a negative effect is not material.
- **Factor B – likelihood of occurrence.** Where an effect is material from a size and nature perspective, as in Factor A, I have then considered the likelihood of occurrence. For example, if an effect is potentially material in size and nature, but is highly unlikely to occur, I may not consider this to be an adverse effect in relation to the Statutory Question. If however an effect is potentially material in size and nature and is more probable than not to occur, I would consider this to be an adverse effect in relation to the Statutory Question and hence consider Factor C below.

This means that my approach results in consideration of effects which are less probable than not to occur where I consider this to be a realistic possibility. I believe that this is also consistent with the principles adopted by the England and Wales High Court on 9 March 2018 in the matter of Barclays Bank plc and Woolwich Plan Managers Limited.

- **Factor C – mitigating activities.** Where having considered the size, nature and likelihood, I believe that there may remain an adverse effect in relation to the Statutory Question, I have

then considered whether there are any mitigating activities or measures that RBS proposes to take to reduce the adverse nature of the effect.

Whilst I have not considered the effects of wider activities that will occur to ensure compliance with ring-fencing requirements, I have considered the effects of activities that are undertaken because of the Scheme. For example I consider mitigating activities undertaken to minimise the effect of the Scheme to themselves be effects of the Scheme. For example, I consider that the communication with customers is itself an effect of the Scheme.

Where, having considered these factors, I believe that an effect remains which is likely adversely to affect Stakeholders (an "Adverse Effect"), I have answered part (b) of the Statutory Question. I have therefore made use of a "materiality concept". My approach to the consideration of adverse effects is in line with the PRA Statement of Policy and the FCA Guidance in respect of skilled persons reports on ring-fencing transfer schemes which refer to consideration of material effects.

In answering part (b) of the Statutory Question, I have assessed whether I believe that the Adverse Effect is greater than reasonably necessary in order to achieve the relevant ring-fencing purpose. This is set out in Section 106B(3)(a) of FSMA, which for the purposes of the Scheme is "enabling a UK authorised person to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions". In making my assessment I have considered whether alternative arrangements or specific mitigating measures could reasonably have been put in place to reduce the Adverse Effect and still achieve the relevant ring-fencing purpose. In making my assessment of what is reasonable, I have considered a number of factors, depending on particular facts and circumstances. Some key principles in my assessment are set out below:

- In respect of each Adverse Effect, I have considered whether it would be reasonable to undertake an activity or put a measure in place to mitigate the Adverse Effect. For example, if I believe that a mitigating action is relatively simple to put in place, such as the waiving of additional rights that any one or more of the Scheme Companies may gain which it previously did not have, I may consider that it would be unreasonable not to put such a mitigation in place. I note that the Scheme Document reflects RBS's final decisions on the design of the Scheme and in a number of cases, negative outcomes have been mitigated and hence I have not had to conclude on part (b) of the Statutory Question in respect of these cases.
- In respect of each Adverse Effect, I have considered whether alternative arrangements could have reasonably been put in place to reduce the Adverse Effect. Alternative arrangements may have different effects on different groups of Stakeholders and in making my assessment, I have considered whether the alternative arrangements may result in an Adverse Effect for one group of Stakeholders being reduced only for other negative outcomes to be created for other Stakeholders. For example, if the Adverse Effect is relatively small and an alternative arrangement would create larger negative outcomes for other Stakeholders, I may conclude that the planned course of action is reasonable.

This Scheme Report considers the effects of the Scheme for the Stakeholders of the Companies, and sets out my findings. I am not required to, and do not, consider the position of each Stakeholder, but I have reviewed the consequences for each group of Stakeholders at the level I regard necessary to satisfy the requirements of the PRA Statement of Policy and FCA Guidance.

To the best of my knowledge, I have taken account of all important facts in assessing the effect of the Scheme on Stakeholders and in preparing this Scheme Report. In order to reflect any updated financial information or circumstances nearer to the date of the Final Hearing, I will provide a Supplementary Report setting out my updated opinions in respect of the Scheme.

1.4.4 Effects of the Scheme

The Scheme is only one of the activities that the RBS Group is undertaking in order to ensure compliance with all ring-fencing requirements by 31 December 2018.

My Scheme Report only covers the effects of the Scheme itself. I note that there may be other effects for Stakeholders, including those which may be adverse, which are the result of the other activities being undertaken by RBS to ensure ring-fencing compliance. I have not commented on whether other adverse effects may be caused by these other activities as these are outside of the scope of my work.

Whilst my Scheme Report only covers the effects of the Scheme, for information purposes I have summarised in Section 3 my understanding of the other key activities that are occurring related to achieving compliance with the ring-fencing requirements. These other activities include the First Scheme which transferred the personal and corporate banking business of NatWest Markets to The Royal Bank of Scotland plc ("RBS plc", formerly known as Adam & Company plc), the Covered Bonds Business to NatWest Bank, and property from NatWest Markets to both RBS plc and NatWest Bank. This is separate to the Scheme being considered in this Scheme Report and is subject to a separate skilled person's scheme report, which as noted in 1.2 has been prepared by me, and Court application. There will also be a reorganisation of the RBS Group legal entity structure, transfers of contracts by novation, transfers of systems and other operational infrastructure and changes to RBS employer companies.

My consideration of the effects of the Scheme covers both existing contractual relationships that Stakeholders may have, together with the Scheme Companies' "invitations to treat," being offers to enter into a contract with the Scheme Companies. I note that RBS has the ability to make changes post the Scheme which may affect matters such as the setting of rates and charges and products offered. Such decisions are driven by a wide variety of factors and management of RBS can decide to change its strategy in the future. My Scheme Report only covers the effects of the Scheme and I cannot comment on future strategic decisions that may be made.

1.4.5 My duties

In reporting on the Scheme as the skilled person, I recognise that I owe a duty to the Court to assist on matters within my expertise. This duty overrides any obligation to the Companies. I believe that I have complied, and confirm that I will continue to comply, with this duty.

Readers of my Scheme Report may find it helpful to read some of the other related Scheme documents (see Appendix 4 for details on these documents, which can be obtained online or will be mailed on request). I have reviewed the Scheme related documents to ensure they are consistent with my own findings and I note in Appendix 4 where I have relied specifically upon a document or opinion.

1.5 Sources of information

In performing my review and preparing this Scheme Report, I have relied on the accuracy and completeness of data and information provided to me, both written and oral, by management of the RBS Group. A description of the categories of data and information provided is included in Appendix 4.

Although I have not verified the data and information provided to me, I have reviewed it for reasonableness and consistency using my experience of the banking industry. In doing this, I have:

- Considered the source of the data and information provided and RBS's governance process in respect of the data and information provided;
- Corroborated the data and information provided, as appropriate, through interviews with individuals within the RBS Group with knowledge of the issues under consideration; and
- Reviewed the results of the legal due diligence exercise performed by the RBS Group in respect of the ability to transfer the business, assets and liabilities and the legal effects of the Scheme. This work has been undertaken by legal professionals in the RBS Group legal department. I have reviewed the results of the work undertaken and considered the results in

my Scheme Report. Although I did not check the underlying work performed, I asked the RBS Group to explain the approach undertaken, including the scope of the Stakeholders covered by the work, and to explain or clarify the results as appropriate. This included holding discussions with members of the RBS Group legal department.

In performing the procedures above, I can confirm that all my queries have been answered to my satisfaction.

Due to a combination of legal, regulatory and commercial sensitivities, some of the information I have relied upon to reach my conclusions cannot be disclosed in a publicly available report such as this. However I can confirm that appropriate detailed information has been provided to me to enable me to form the opinions I express to the Court in this Scheme Report.

Further details are provided below:

1.5.1 Financial position

My analysis of the financial position of NatWest Bank and NatWest Markets is based on profitability projections and capital and liquidity calculations; the capital and liquidity requirements being set out in UK regulations. The estimates have been prepared by the RBS Group and are referred to in later sections of this Scheme Report. I have not checked these estimates or the processes used to calculate them and have relied on them in carrying out my analysis. I believe this is reasonable since the models, processes, and data used to estimate the pre- and post-Scheme positions of NatWest Bank and NatWest Markets are well established and where processes have been amended in order to update estimates for the purpose of the Scheme, these have been subject to additional governance procedures within the RBS Group.

Although I did not check the figures or the underlying processes:

- RBS has confirmed to me that the underlying forecast financial data had been estimated using established RBS forecasting processes and models;
- I reviewed how RBS has estimated the effects of the Scheme on the underlying financial data and the effects on individual legal entity projections. This has included for example, understanding the key assumptions, consideration of the transfers of assets and liabilities as a result of the Scheme and associated financial effects such as revenue allocations, cost allocations, funding implications and the proposed allocation of specific one-off items; and
- I have reviewed the results of the stress testing performed by RBS in respect of the financial projections. RBS have confirmed that this has been subject to RBS governance processes.

I asked RBS to explain, check and/or clarify any results that seemed to me unreasonable or inconsistent with other data and information. All such queries have been answered to my satisfaction.

As part of my analysis, I have considered financial projections provided by the RBS Group of the expected capital and liquidity position of the Scheme Companies at the proposed Effective Date. I note that the financial position at the Effective Date cannot be predicted with certainty. The capital position of NatWest Bank and NatWest Markets at the Effective Date will therefore likely differ to some degree from the projections I have considered. For that reason I will continue to keep the position under review in the period leading up to the Final Hearing, and will prepare further information in a Supplementary Report as appropriate.

1.5.2 Legal advice

The RBS Group has undertaken legal due diligence in respect of the ability to transfer business and customers and the legal effects of the Scheme. As stated above, I have reviewed the results of the

work undertaken and considered the results in my Scheme Report. As I am not a qualified legal professional, where I believe that the effects of the Scheme are dependent on the operation of a matter that involves legal judgement, I have been provided with legal advice on the matter. I note that this has been provided by Linklaters LLP, a legal adviser retained by the RBS Group to provide advice in respect of the Scheme. Linklaters LLP is a large legal firm and it is my view that they have the relevant and appropriate qualifications and knowledge of the laws and regulations governing banking transfers in the UK in order to provide such advice. I am therefore satisfied that it is appropriate for me to rely on the conclusions of Linklaters LLP on the relevant matters.

1.5.3 Future plans

As my Scheme Report is written before the Effective Date, in reaching my conclusions I have relied on data and information provided by the RBS Group in respect of activities that are planned to occur in the future. As these plans have been approved through the RBS Group's internal governance process, I believe that it is appropriate for me to reach my conclusions on the basis that these plans will be delivered by the RBS Group.

Although the future plans remain the responsibility of the RBS Group, I asked the RBS Group to explain the process by which the plans had been drawn up, how plans were put in place to cover Scheme changes, the governance process over the plans and how the delivery and implementation of plans will be monitored. All such queries have been answered to my satisfaction.

There are certain approvals from regulatory and other bodies that may need to be obtained prior to the Effective Date. RBS believes that all required approvals should be given. The conclusions in this Scheme Report are based on the assumption that such approvals will be obtained.

I note that future plans can change. I will continue to keep the position under review in the period leading up to the Final Hearing, and will update my conclusions in a Supplementary Report as appropriate.

1.5.4 Communication plans

As my Scheme Report is written before the Effective Date, in reaching my conclusions I have taken into account planned communications to Stakeholders. Where already drafted, I have reviewed the planned communications. Where communications will be finalised in the future, I have reviewed the high level content of the communication and the governance structure in place to ensure that the communication is made as planned.

I note that future plans can change. I will continue to keep the position under review in the period leading up to the Final Hearing, and will update my conclusions in a Supplementary Report as appropriate.

1.6 Limitations

This Scheme Report has been prepared solely for the use of the Companies and the Court, and solely for the purpose of assisting in determining whether the Scheme should be permitted.

This Scheme Report is subject to the terms and limitations, including limitations of liability set out in my engagement letter dated 25 January 2018.

For the avoidance of doubt neither I nor Deloitte, its partners and staff owe or accept any duty to any other party and shall not be liable for any loss, damage or expense (including interest) of whatever nature which is caused by any other party's reliance on representations in this Scheme Report.

Both Deloitte and I have excluded liability to avoid having potential liability to an unlimited number of people. Without this exclusion, neither Deloitte nor I would be able to do this work. If any readers are concerned with the content of this Scheme Report or any part of my analysis they should take advice and raise the matter with the Court. If any reader thinks that they would be

adversely affected by the carrying out of the Scheme, they have two alternative ways of making sure the Court considers their views: lodging formal objections with the Court or making informal objections in writing or in person.

If a person wishes to lodge formal written objections (known as "Answers") with the Court, they should seek independent legal advice. Answers are a formal Court document which must comply with the rules of the Court and are normally prepared by Scottish legal counsel. Answers must be lodged with the Court at Parliament House, Parliament Square, Edinburgh EH1 1RQ, within 42 days of the publication of the last of the notices relating to the Scheme, which is expected to be on or around 18 May 2018. The deadline for lodging Answers is 29 June 2018. In addition, Answers must also be accompanied by a fee to the Court.

The Court will also consider any other informal objections to the Scheme which are made in writing or in person at the Final Hearing. If a person wishes to object in writing or in person at that hearing, they need to send a written statement of their views to all of the following:

- By post or by hand to the Court at the above address;
- NatWest Bank, either
 - by post or by hand to 250 Bishopsgate, London, EC2M 4AA; or
 - by email to ringfencing@natwestmarkets.com; and
- the Prudential Regulation Authority, either:
 - by post or by hand to National Westminster Bank, Prudential Regulation Authority, Bank of England, Threadneedle Street, London EC2R 8AH; or
 - by submitting it online at <http://www.bankofengland.co.uk/pru/Pages/authorisations/structuralreform/representations.aspx>

They need to do this by 5pm on 11 July 2018 in order to ensure the Court will consider their objection at the Final Hearing. No fee is payable to the Court for objecting in this way.

The Court is also likely to consider any objections whether made in writing or in person at the Final Hearing, although it might not do so if the process for objecting described above has not been followed.

This Scheme Report should be considered in its entirety, as parts taken in isolation may be confusing. A copy of my Scheme Report is being provided to the following parties:

- The Court, to assist in determining whether the Scheme should be approved;
- The Regulators, for the purposes of the performance of their statutory obligations under FSMA; and
- Legal advisers of NatWest Bank and NatWest Markets in connection with the Scheme Report provided that NatWest Bank and NatWest Markets inform them that neither Deloitte nor I accept any responsibility or liability to them in respect of any use they may make of the Scheme Report.

A copy of this Scheme Report is to be published on the websites of the Companies and made available for inspection at the following offices of the Companies and two offices of the Companies' Scottish legal advisers, CMS Cameron McKenna Nabarro Olswang LLP.

- NatWest Bank: 250 Bishopsgate, London EC2M 4AA
- NatWest Markets: 36 St. Andrew Square, Edinburgh EH2 2YB
- CMS Cameron McKenna Nabarro Olswang LLP: Saltire Court, 20 Castle Terrace, Edinburgh EH1 2EN and Cannon Place, 78 Cannon Street, London EC4N 6AF

A copy of this Scheme Report will be provided by RBS upon request to any person who considers they may be adversely affected by the Scheme. Otherwise, this Scheme Report (or any extract

from it) should not be published without the prior written consent of Deloitte. My summary of the Scheme Report will be made available by the Companies to the customers of the Scheme Companies with an interest in the Scheme. No other summary of this Scheme Report may be made without the prior written consent of Deloitte.

2 Conclusion

For the reasons set out in the remainder of this Scheme Report, I have concluded that, save in respect of certain matters set out in Section 5, (a) persons other than the transferor are not likely to be adversely affected by the Scheme and, in relation to the matters set out in Section 5 where I have identified an Adverse Effect, (b) if they are likely to be adversely affected, the Adverse Effect is not likely to be greater than is reasonably necessary in order to achieve the specific purpose of enabling a UK authorised person to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions (Section 106B(3)(a) of FSMA).

I have set out in this Scheme Report the basis of my conclusions in respect of different groups of Stakeholders, communications with them and a range of cross-Stakeholder matters:

- In Section 5 I have considered the effects of the Scheme on Stakeholders transferring from NatWest Bank to NatWest Markets and I have concluded that there are certain Adverse Effects. Hence I have considered part (b) of the Statutory Question, and I have concluded that where there is an Adverse Effect, it is not likely to be greater than is reasonably necessary to achieve the specific purpose of Section 106B(3)(a) of FSMA;
- In Section 6 I have considered the effects of the Scheme on a range of other Stakeholders, and I have concluded that there is no Adverse Effect;
- In Sections 7 to 12 I have considered a range of cross-Stakeholder matters such as financial considerations, tax, governance and communications.

In setting out my opinions in this Scheme Report, I confirm that I understand my duty to the Court and that I must help the Court on matters within my expertise. I believe that I have complied, and will continue to comply, with this duty. I confirm that I have made clear which facts and matters referred to in this Scheme Report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer.

This conclusion should be read in conjunction with the limitations I have set out in Section 1.6 of this Scheme Report.

Oliver Grundy MA, FCA
11 May 2018

3 Overview and purpose of the Scheme

In response to the financial crisis, the UK government established the Independent Commission on Banking ("ICB") to investigate how the UK banking system could be reformed to improve financial stability and increase competition. In its final report published in September 2011, the ICB proposed, amongst other measures, the 'ring-fencing' of core retail banking services from risks unrelated to the provision of that service.

The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 requires that from 1 January 2019, banks which have over a period of three years average Core Deposits¹ of more than £25 billion, will be subject to ring-fencing requirements. These requirements stipulate that the provision of the core activity of accepting deposits from individuals and small businesses is placed into ring-fenced bodies ("RFBs"). The RBS Group is required to comply with the ring-fencing legislation given the size of its Core Deposits has been greater than £25 billion over the applicable period.

The ring-fencing legislation is wide-ranging and as set out in Section 3.3, RBS is conducting various activities in order to ensure compliance with the legislation by the deadline of 1 January 2019.

Under the ring-fencing legislation, RFBs are prohibited from undertaking certain "excluded activities", including the regulated activity of "dealing in investments as principal", subject to certain exceptions (Article 4 of The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions Order) 2014 ("EAPO")). For these purposes, "dealing in investments as principal" generally has the meaning given to it in Article 14 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("RAO"). The relevant definition includes "buying, selling, subscribing for or underwriting securities or contractually based investments as principal", unless such dealing falls within certain exceptions in the RAO (some of which are "switched off" for the purposes of the ring-fencing legislation).

For these purposes, derivative transactions are contractually based investments where the value of the contract is determined by fluctuations in one or more underlying reference rates ("Derivative Transactions"). Buying or selling a Derivative Transaction will therefore constitute dealing in investments as principal unless an exception applies. As a result, RFBs are not permitted to buy or sell Derivative Transactions as principal unless an exception applies.

It is derivative business (and specifically, buying and selling Derivative Transactions as principal) which is relevant to this Scheme.

The EAPO sets out various exceptions which allow RFBs to deal in Derivative Transactions as principal if certain criteria are met. In particular, client-facing transactions satisfying the criteria in Articles 9 to 12 of the EAPO ("Eligible Derivative Transactions") may be carried out by RFBs. These exceptions do not apply, however, if the counterparty is a relevant financial institution as defined in Article 2 of EAPO, which comprises broadly financial institutions, such as non ring-fenced banks, investment firms, investment funds and managers thereof ("RFI"). This exclusion is set out in Article 9 of EAPO.

There are also certain transitional provisional arrangements ("Grandfathering Provisions") set out in Article 21 of the EAPO. These permit certain types of Derivative Transactions which would normally be excluded under the above criteria to be held in the RFB. These Derivative Transactions must mature no later than 31 December 2020. RBS intends to utilise these provisions for any

¹ Broadly deposits with a UK bank held in an account within the European Economic Area ("EEA") from individuals and small businesses

interest rate Derivative Transactions that fall within this window (and hence they are included within the definition of "Eligible Derivative Transactions" for the purposes of this Scheme Report). RBS does not intend to utilise these Grandfathering Provisions for any 'qualifying' FX Derivative Transactions, and the reasons are discussed in Section 5.3.2.1.

The Grandfathering Provisions also provide an exception to the RFI exclusion in Article 9. These provisions permit any Derivative Transaction with an RFI that matures on or before 31 December 2020 to be held by an RFB. Therefore, subject to the FX exclusion detailed above, these Derivative Transactions are also included in the definition of "Eligible Derivative Transactions".

The ring-fencing legislation, as set out in Article 6 of the EAPO, also permits a RFB to continue to hold and execute Derivative Transactions which are used for its own risk and liquidity management purposes ("Risk Management Derivative Transactions"). As discussed below, these Risk Management Derivative Transactions are not being transferred as part of the Scheme.

In addition, for operational reasons, RBS will also exclude any Derivative Transaction maturing prior to 31 August 2018 ("Excluded Derivative Transactions"). RBS has extended the exclusion period to minimise execution risk of the Scheme arising from Derivative Transactions settling on or shortly after the Effective Date. Any such Derivative Transaction can remain with NatWest Bank as it will mature in advance of the ring-fencing legislation coming into force on 1 January 2019.

Any Derivative Transaction, other than those defined above as either Eligible Derivative Transactions, Risk Management Derivative Transactions or Excluded Derivative Transactions, is considered an Ineligible Derivative Transaction. This also includes any Derivative Transactions entered into after the cut-off date for the opt-out process (as detailed in Section 12.5), unless such a Derivative Transaction matures prior to 31 August 2018, as it will be considered an Excluded Derivative Transaction. Any such Ineligible Derivative Transaction will not be eligible for opt out and will transfer under the Scheme.

For illustration purposes, examples of Eligible Derivative Transactions are simple interest rate swaps, currency swaps, overnight index swaps, forward rate agreements, foreign exchange forwards and foreign exchange swaps, provided that such transactions comply also with the other relevant criteria of the ring-fencing legislation. Examples of Ineligible Derivative Transactions are dual rate swaps, discount swaps, inflation linked Derivative Transactions and foreign exchange time options.

3.1 Background and purpose of the Scheme

The Financial Services (Banking Reform) Act 2013 created an additional form of court sanctioned banking business transfer scheme known as a ring-fencing transfer scheme under Part VII of FSMA ("RFTS"). It is designed to aid banking groups which are implementing ring-fencing to restructure their businesses to comply with the ring-fencing requirements.

To take effect, the PRA, in consultation with the FCA, must give consent to RBS's application to Court, and is required to issue a certificate of approval 'certifying its approval of the application' before the Court may make an order to sanction the Scheme. To aid the Court in its decision as to whether to sanction the Scheme, the Court must be provided with a report on the Scheme prepared by an independent skilled person. I am the skilled person for the Scheme and this is my Scheme Report.

The Scheme Report must specifically address:

- (a) whether persons other than the transferor concerned are likely to be adversely affected by the scheme; and
- (b) if so whether the adverse effect is likely to be greater than is reasonably necessary in order to achieve whichever of the purposes mentioned in Section 106B(3) of FSMA is relevant.

The purposes outlined in Section 106B(3) of FSMA are as follows:

- a) enabling a UK authorised person to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions;
- b) enabling the transferee to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions;
- c) making provision in connection with the implementation of the proposals that would involve a body corporate whose group includes the body corporate to whose business the scheme relates becoming a ring-fenced body while one or more other members of its group are not ring-fenced bodies;
- d) making provision in connection with the implementation of proposals that would involve a body corporate whose group includes the transferee becoming a ring-fenced body while one or more members of the transferee's group are not ring-fenced bodies.

This is referred to as the Statutory Question and, in relation to the Scheme, the transferor is NatWest Bank, the transferee is NatWest Markets and the relevant purpose is section 106B(3)(a) of FSMA i.e. enabling a UK authorised person to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions.

In this case NatWest Bank is the UK authorised person, and the transfer of the customer derivative business (and in particular any Ineligible Derivative Transactions contained within) is to ensure that going forward it will operate as a ring-fenced body in compliance with the ring-fencing provisions.

3.2 Summary of proposed transfers under the Scheme

As part of the RBS Group's overall strategy to achieve compliance with the ring-fencing legislation, RBS has taken the strategic decision to conduct customer derivative business from NatWest Markets, where the majority of existing Derivative Transactions reside and with whom the majority of existing Derivative Transaction counterparties currently transact. To facilitate the execution of this strategy, the Scheme is being used to transfer certain existing Derivative Transactions and arrangements in place between counterparties and NatWest Bank to NatWest Markets. The Scheme Document sets out full details of the agreements, assets and liabilities that are transferring as part of the Scheme. It is proposed that both Eligible and Ineligible Derivative Transactions will transfer as part of the Scheme although counterparties will be offered the opportunity to leave Eligible Derivative Transactions within NatWest Bank, if they so choose. This is discussed further in Section 5 of this report.

Risk Management Derivative Transactions and Excluded Derivative Transactions will also not transfer as part of the Scheme.

The following contracts and arrangements are intended to transfer through the Scheme:

| | Category | Description | Eligible Derivative Transactions (indicative volumes as at 28 February 2018) | Ineligible Derivative Transactions (indicative volumes as at 28 February 2018) |
|----|---|--|--|--|
| 1) | Transactions governed by ISDA Master Agreements | Transactions entered into between a counterparty and NatWest Bank will transfer as part of the Scheme together with the applicable ISDA Master | 2,089 | 1,726 |

| | | | | |
|----|--|--|-------|-------|
| | | Agreement governing those transactions, schedules long and short form confirms and title transfer collateral arrangements. | | |
| 2) | Transactions entered into on the "Agile Markets" system | Agile Markets is an electronic web-based interface with RBS that allows counterparties to transact business with it. Transactions entered into between a counterparty and NatWest Bank on Agile Markets will transfer as part of the Scheme together with the associated Agile Markets terms of business and confirmations generated by that system. | 5,035 | 6,270 |
| 3) | Standalone Derivative Transactions which are not covered by a master agreement | Transactions governed by RBS's standalone Derivative Transaction terms. | 830 | 616 |
| 4) | Secured Empty Arrangements | Any ISDA Master Agreement or "Agile Markets" terms of business between NatWest Bank and a counterparty where there are no live transactions at the Effective Date, but where there is an all monies security arrangement in place. | N/A | N/A |

In addition:

| | | |
|----|------------|---|
| 5) | Litigation | Any existing claims or litigation associated with the transferring business will transfer along with the business, with the exception of any claim or litigation associated with any opted-out Derivative Transactions or related arrangements which will remain in NatWest Bank. |
| 6) | Collateral | Any collateral posted against transferring transactions will transfer along with the transactions. |

I have considered in Section 5 whether I think this Scheme results in any Adverse Effect for transferring counterparties, and if so, whether this is reasonable to achieve the designated purpose.

3.3 Other activities to achieve ring-fencing

The Scheme is only one of the activities that the RBS Group is undertaking in order to ensure compliance by 31 December 2018 with all ring-fencing requirements. Whilst my Scheme Report

covers the Scheme, for information purposes I have summarised my understanding of the other key activities that have occurred or are occurring related to achieving compliance with the ring-fencing requirements. These descriptions are only included for information purposes as my Scheme Report only considers adverse effects caused by the Scheme. Whilst these other activities are not the subject of this Scheme Report, I believe that it is important that the Stakeholders are aware of the wider reorganisation so that the effect of the Scheme can be considered in the context of these wider activities.

I have not commented on whether other adverse effects may be caused by these wider activities.

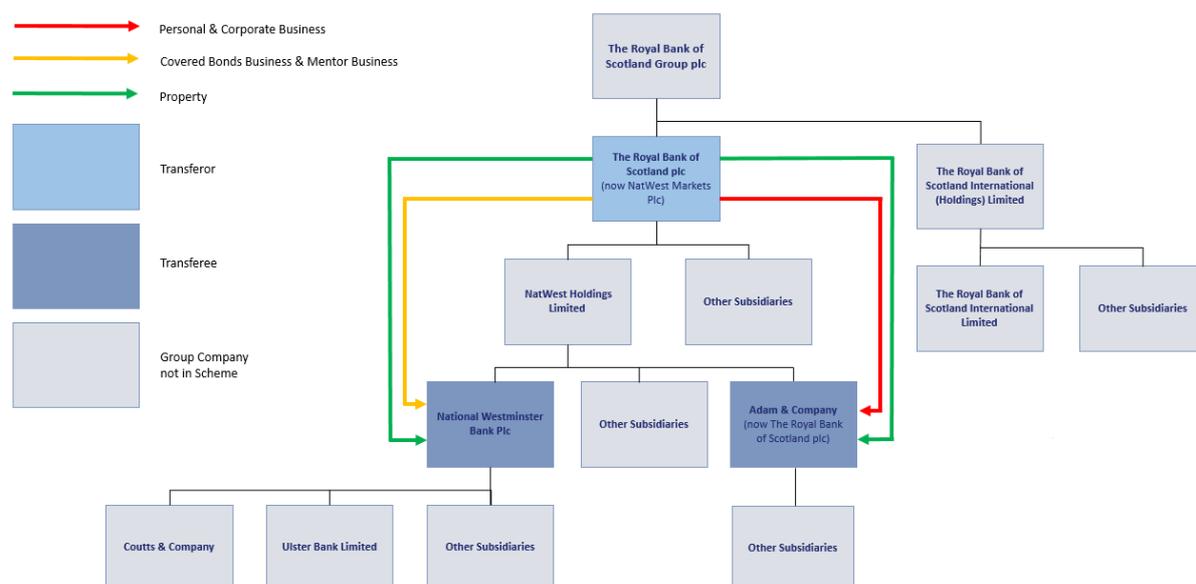
Key other activities outside the Scheme include:

3.3.1 First ring-fencing transfer scheme

RBS has implemented another ring-fencing transfer scheme which transferred the personal and corporate banking business of RBS plc to Adam & Company, transferred the Covered Bonds Business and Mentor Business of RBS plc to NatWest Bank and transferred property from RBS plc to both Adam & Company and NatWest Bank. As the Scheme was implemented, RBS plc was renamed NatWest Markets, and Adam & Company was renamed RBS plc. This was separate to the Scheme being considered in this Scheme Report and was subject to a separate skilled person's scheme report and Court process.

The First Scheme took effect on 30 April 2018.

The First Scheme transfers are shown in Figure 3-1 below:



3.3.2 Employees

On 1 May 2018 the majority of employees that support the RFB Subgroup transferred from RBS plc (now NatWest Markets) to NatWest Bank. NatWest Bank is now the main employing entity for the RFB Subgroup (for itself, and as the provider of shared services to the RFB Subgroup and the entities outside the ring-fence).

This transfer occurred on the basis of a "service provision change" under the Transfer of Undertakings (Protection of Employment) Regulations 2006. There was a termination of any existing service provider arrangements between RBS plc (now NatWest Markets) and other

relevant group companies, and NatWest Bank has been appointed the new employment services provider for the relevant entities within the RFB Subgroup, including shared services staff, some of whom will provide services to entities outside the ring-fence.

3.3.3 RBS Group reorganisation

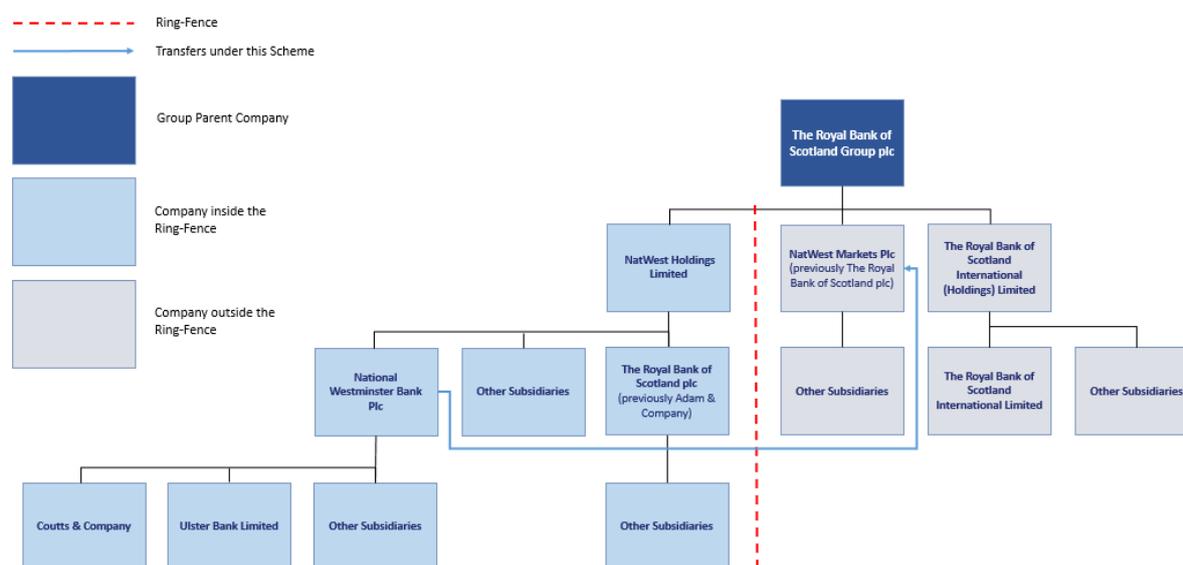
In 2018, following the effective date of the First Scheme but prior to the Effective Date of this Scheme, the RFB Subgroup will be "separated" from NatWest Markets. NatWest Markets will become an NRFB and will reside outside the ring-fence along with other entities such as The Royal Bank of Scotland International (Holdings) Limited which was transferred to RBSG plc on 1 January 2017 so that it became a direct subsidiary of RBSG plc.

As part of the plan to achieve this, NatWest Markets proposes to implement a capital reduction. The company will therefore apply to the Court for a reduction of capital under Section 641 of the Companies Act 2006. This application will seek approval to reduce share capital and certain undistributable reserves of NatWest Markets. If sanctioned by the Court, it is intended that the capital will be returned to its shareholder, RBSG, through the transfer of NatWest Markets' ownership of NatWest Holdings and its subsidiaries to RBSG and also in cash, with any balance remaining as distributable reserves.

As such a reduction will require the approval of the Court, NatWest Markets will make a separate application for this approval (separate, that is, from the application for the Court's approval of this Scheme).

In deciding whether to approve NatWest Markets' application, the Court will consider the interests of creditors, the effect the capital reduction will have on their position as creditors, and NatWest Markets' ability to continue to be able to settle its liabilities to those creditors. As that Court process is separate from the Scheme, it is not within the scope of this Scheme Report.

Following this, the RFB Subgroup will become a direct subsidiary of RBSG plc, as shown in Figure 3-1 below.



3.3.4 Other business transfers

There are a number of other business transfers that are planned to occur prior to 31 December 2018 in order to ensure compliance with ring-fencing requirements. These include the migration of certain customers from NatWest Bank to The Royal Bank of Scotland International Limited ("RBSI") and the migration of certain customers and activities from other entities which will form

part of the RFB Subgroup (e.g. Ulster Bank Limited ("Ulster Bank"), Coutts & Company ("Coutts")) to either NatWest Markets or RBSI. These are in relation to activities that will not be permitted in RFB entities post the implementation of ring-fencing requirements. These transfers are occurring by client consent and are not within the scope of the Scheme.

3.3.5 Operations, systems and infrastructure

In order to comply with ring-fencing requirements, certain central functions and other support services will be reorganised so that they are all provided by NatWest Bank, both to itself and to the rest of the RBS Group, including the NRFB. Current service arrangements will be replaced by a new servicing structure, underpinned by a series of intra-group service agreements entered into by the RBS Group entities.

As a result, certain infrastructure such as systems and contracts will be moved to NatWest Bank. This will occur outside the scope of the Scheme.

4 My role as the skilled person

As set out in Section 1, my role is to produce a Scheme Report to address the Statutory Question of (a) whether persons other than the transferor concerned are likely to be adversely affected by the scheme, and (b) if so, whether the adverse effect is likely to be greater than is reasonably necessary in order to achieve whichever of the purposes mentioned in Section 106B(3) of FSMA is relevant. This Scheme Report provides my independent assessment of the effect of the Scheme to assist the Court in deciding whether to sanction the Scheme. I am independent of RBS, and my appointment has been approved by the PRA, one of the bodies that regulates the UK banking industry. The PRA consulted with the FCA as part of the process to approve my appointment.

In making this judgement, I have considered whether the Scheme results in an Adverse Effect in:

- Services to Stakeholders and operational continuity for Stakeholders: being the effect of the Scheme on the services provided to the Stakeholder, the quality of the operational continuity arrangements of the entities to which Stakeholders are exposed or connected and the ability of the entities to continue to provide these services to those Stakeholders;
- Financial Considerations: being the effect of the Scheme from a financial perspective on Stakeholders. This will include for example consideration of the effect of the Scheme on: i) terms and conditions and other financial effects on rates and fees; ii) the capital position of the entities to which Stakeholders are exposed or connected on a risk weighted and leveraged basis; iii) the liquidity and funding position of the entities to which Stakeholders are exposed or connected; iv) the effect on the business-model viability and sustainability of the entities to which Stakeholders are exposed or connected; and v) the position of persons other than the transferor in the creditor hierarchy;
- Risk management and governance: being the effect of the Scheme on the quality of governance arrangements and the quality of risk management and the systems and controls of the entities to which Stakeholders are exposed or connected; and
- Recovery and Resolution: being the effect of the Scheme on recovery planning, and the ability of the RBS Group to be resolved.

I can confirm that my assessment in respect of parts (a) and (b) of the Statutory Question includes consideration of:

- changes to customers' position, and how a negative effect is addressed, in the following areas: penalties or other impediments, if any, connected to the proposed transfer; exercisable rights to set-off loans against deposits; customers' and counterparties' other contractual rights;
- the continuity and levels of service;
- whether rights in relation to complaints, legal or other proceedings against NatWest Bank (in relation to those already commenced or threatened, or proceedings in the future, including those not yet anticipated) are preserved or otherwise;
- whether rights to financial redress for legacy liabilities of NatWest Bank for mis-selling of financial products are affected;
- whether product terms and conditions, including product benefits and outcomes for customers, will be affected by the Scheme;
- whether product administration, including fees and other costs, may be affected on transfer;

- the amount of client money transferred and the terms of the transfer to ensure protections under the FCA's client money rules are preserved;
- in relation to customers being transferred to another entity, any adverse change to the level of consumer protection afforded by the availability of adequate resources of NatWest Markets; and
- the likely effects of the Scheme on IT systems, operating models and matters such as governance, management, business strategy and financial positions, in so far as they may be likely to affect customers adversely and are a direct consequence of the scheme rather than other factors for example, legacy issues or ongoing change programmes.

I have considered the effect that the Scheme will have on individual Stakeholder groups in the following sections of my Scheme Report.

- Section 5: Customers and counterparties transferring from NatWest Bank to NatWest Markets under the Scheme (Effect on Transferring Customers); and
- Section 6: Other Stakeholders, including existing customers and counterparties of NatWest Bank and NatWest Markets (Effect on other Stakeholders).

Within each of these broad groups, I have considered separately the interests of different sub-groups, since the factors influencing them are different.

Some considerations affect multiple groups of Stakeholders. As such I have set out my key considerations and conclusions in Sections 7 to 12:

- Section 7: Financial considerations
- Section 8: Governance and risk management considerations
- Section 9: Operational considerations
- Section 10: Resolvability considerations
- Section 11: Tax considerations
- Section 12: Communications

5 Effect on Transferring Counterparties

5.1 Introduction

In this Section I have considered the effect of the Scheme on counterparties whose Derivative Transactions are proposed to be transferred from NatWest Bank to NatWest Markets. Section 3 sets out a summary of the types of Derivative Transaction contracts and arrangements that will be transferred and in this Section I have considered the effects of the proposed transfers.

A number of different types of Derivative Transaction are being transferred. I have split my analysis into the following three Stakeholder Groups:

- Counterparties with only Ineligible Derivative Transactions. These are counterparties that only have Derivative Transactions with NatWest Bank which would be classified as Ineligible on the basis that NatWest Bank as a RFB cannot hold such Derivative Transactions following the implementation of the ring-fencing legislation. These are covered in Section 5.3;
- Counterparties with only Eligible Derivative Transactions (including those with grandfathered interest rate Derivative Transactions). These are counterparties that only have Derivative Transactions with NatWest Bank which would be classified as Eligible on the basis that NatWest Bank as a RFB can hold such Derivative Transactions following the implementation of the ring-fencing legislation. These are covered in Section 5.4; and
- Counterparties with both Ineligible and Eligible Derivative Transactions. These are covered in Section 5.5.

5.2 Approach

I have considered how the Scheme affects Stakeholders both from a financial perspective and in terms of the provision and operational continuity of services to Stakeholders. The factors I have considered include:

- The effect on contracted terms and conditions and contracted rates/fees;
- The effect on the credit risk of exposures (e.g. security/collateral arrangements, financial strength of the entity providing the service);
- The effect on hedge accounting potentially adopted by counterparties;
- The effect on other rights such as:
 - Security provided by the counterparty,
 - Set-off rights,
 - Netting rights;
- Tax considerations;
- Other contractual provisions;
- Access to RBS contacts;
- Access to products;
- Service provision from RBS; and

- Electronic connectivity of counterparties to NatWest Bank and NatWest Markets systems.

In performing my review and preparing this Scheme Report, I have relied on the accuracy and completeness of data and information provided to me, both written and oral, by the RBS Group. Although I have not verified the data and information provided to me, I have reviewed it for reasonableness and consistency using my experience of the banking industry. In doing this, I have:

- Considered the source of the data and the information provided and RBS's governance process in respect of the data and information provided;
- Corroborated the data and information provided, for example, through interviews with individuals within the RBS Group with knowledge of the issue under consideration; and
- Reviewed the results of the legal due diligence exercise performed by the RBS Group in respect of the ability to transfer the business, assets and liabilities and the legal effects of the Scheme. This work has been undertaken by legal professionals in the RBS Group legal department. I have reviewed the results of the work undertaken, discussed it with members of the RBS Group legal department and considered the results in my Scheme Report. Although I did not check the underlying work performed, I asked the RBS Group to explain the approach undertaken, including the scope of the Stakeholders covered by the work, and to explain or clarify the results as appropriate.

Although I have not verified the data and information, in performing the procedures above, I can confirm that all my queries have been answered to my satisfaction.

As my Scheme Report is written before the Effective Date, in reaching my conclusions I have relied on data and information provided by RBS in respect of activities that are planned to occur in the future. As the future plans have been subject to RBS's internal governance process, I believe that it is appropriate for me to reach my conclusions on the basis that these plans will be delivered by RBS.

Although the future plans remain the responsibility of the RBS Group, I asked the RBS Group to explain the process by which the plans had been drawn up, how plans were put in place to cover Scheme changes, the governance process over the plans and how the delivery and implementation of plans will be monitored. All such queries have been answered to my satisfaction.

I note that RBS's future plans can change. I will continue to keep the position under review in the period leading up to the Final Hearing, and will prepare further information in my Supplementary Report should plans change significantly.

5.3 Counterparties with only Ineligible Derivative Transactions

5.3.1 Contracted rates/fees

The proposed Scheme will not result in any changes to obligations in the Derivative Transaction contracts with no changes to contracted rates and fees. The obligations throughout the life of the contract will not change and the calculation of such obligations will remain unchanged. I therefore do not consider that there is an Adverse Effect in this respect.

5.3.2 Credit risk

Whilst the contracted obligations will not change as a result of the Scheme, open Derivative Transaction contracts are proposed to be transferred from NatWest Bank to NatWest Markets. Counterparties to the Derivative Transactions will therefore contract with a different legal entity following the Scheme. Both entities are regulated banks which have to meet regulatory requirements and as set out in Section 7, RBS's financial projections for NatWest Markets indicate that it will be able to continue to meet minimum regulatory requirements in the future period considered by RBS management. As a result I do not consider that the Scheme results in the

Derivative Transaction counterparties being transferred to an entity that is unable to pay its obligations as they fall due.

However whilst NatWest Markets is still expected be able to pay its obligations as they fall due, there may be other effects on counterparties during the term of the instruments. As set out in Section 3, NatWest Markets will be outside the ring-fenced sub-group and as at the date of this report, the public announcements by the credit rating agencies indicate that it is likely that NatWest Markets will have a lower credit rating than NatWest Bank. For the purpose of my analysis, the credit ratings that have been considered are the long-term unsecured debt ratings, which are typically used by counterparties.

As at the date of this Scheme Report, public announcements^[1] have been made by three credit rating agencies in respect of the ratings of NatWest Bank and NatWest Markets following the restructuring of the RBS Group to comply with ring-fencing rules by 1 January 2019:

- One credit rating agency has stated that the outlook for the credit rating of NatWest Bank is positive and that the outlook for the credit rating of NatWest Markets is stable, which indicates an expectation that at some point in the future NatWest Bank will be rated one notch higher than NatWest Markets;
- One credit rating agency has recently upgraded the credit rating of NatWest Bank by one notch and left the credit rating of NatWest Markets unchanged, resulting in a one notch difference as a result of ring-fencing plans; and
- One credit rating agency has recently upgraded the credit rating of NatWest Bank by one notch and downgraded the credit rating of NatWest Markets by two notches, resulting in a three notch difference as a result of ring-fencing.

It is not clear when all rating changes will be made but it is likely that the Scheme will result in a negative effect for Derivative Transaction counterparties as they are being transferred to an entity which is likely to have a lower credit rating. An effect may arise in relation to the fair valuation of Derivative Transactions that counterparties may record for their financial reporting purposes. Derivative Transactions are generally fair valued for accounting purposes and such valuations contain an adjustment that takes into account the risk of default of the entity that is party to the transaction (the "Credit Valuation Adjustment" or "CVA"). There are different methodologies to calculate a CVA but these are often linked to the credit rating of the entity. For example if a Derivative Transaction had a positive fair valuation in the books and records of a counterparty, it may be expected that the fair valuation may be reduced due to the fact the counterparty was, after the Scheme, contracting with a lower rated entity. The Credit Valuation Adjustment in this example would be greater reducing the overall fair valuation. The corresponding entry in the books and records of the counterparty in this case would be to reduce its profits. As noted below, whilst the effect could be limited, it will depend on various factors such as the profile of future exposures, the maturity of the contracts and the CVA methodology used by the counterparty.

Such an effect would not affect all Derivative Transaction counterparties. For example:

- where Derivative Transactions have a positive fair valuation in the books and records of RBS. In such cases there may not be a CVA although I note that fair valuations can change over time and so a Derivative Transaction which currently has a positive fair valuation for RBS could in the future have a positive fair valuation for the counterparty and hence require a CVA.
- Derivative Transaction counterparties which are fully collateralised against the credit risk of RBS will not be affected by this issue as the existence of collateral mitigates the need for a CVA.

I note that the effect on the fair valuation of Derivative Transactions may be limited compared to the effect of changes in other market variables that affect the fair valuation of a Derivative Transaction. Additionally, as set out in the public announcements made to date by the credit rating

^[1] <http://investors.rbs.com/fixed-income-investors/credit-ratings.aspx>

agencies, the expected difference in the credit ratings of NatWest Bank and NatWest Markets may be up to three notches.

Similarly there may be some effect on Derivative Transaction counterparties that are financially regulated where the transfer of contracts to a lower rated entity results in additional regulatory capital requirements. Again, as set out in the public announcements made to date by the credit rating agencies, the expected difference in the credit ratings of NatWest Bank and NatWest Markets is up to three notches.

As there may be some negative effects on certain counterparties in respect of both fair valuation and regulatory capital, and because I cannot assess whether the effect would be material to these counterparties, I have concluded that the Scheme results in an Adverse Effect for certain Derivative Transaction counterparties.

I have therefore assessed Part (b) of the Statutory Question. As these are Ineligible Derivative Transactions, they cannot remain in the RFB. There is a need to transfer the Derivative Transactions from NatWest Bank. I have therefore considered whether the transfers could have been made to another entity or in a manner which prevented any additional credit risk:

- NatWest Markets is the main Derivative Transaction trading entity of the RBS Group and the entity with which most Derivative Transaction counterparties of the RBS Group already trade. As a result, I have concluded that it is reasonable for Derivative Transactions to be transferred into this entity, rather than for example setting up a completely new entity.
- The credit rating of NatWest Markets is influenced by many factors. Given the size and nature of the business in the entity, I do not consider that there is a simple action or set of actions that could have been taken to eliminate the difference in credit rating between NatWest Bank and NatWest Markets.

I have also considered the possibility of collateralising the Derivative Transaction exposures:

- Putting two way collateral agreements in place for all transferring counterparties would reduce the effect for counterparties who are owed money by RBS but would result in a financial cost for counterparties who owe a debt to RBS and I do not consider this to be a reasonable alternative.
- Putting in place one way collateral agreements whereby only RBS posted collateral would largely eliminate credit risk without a cost for counterparties who owe a debt to RBS. However:
 - Counterparties currently have a credit risk exposure to NatWest Bank through the Derivative Transactions. The introduction of a one way collateral agreement would eliminate this credit risk and hence counterparties would receive a benefit greater than the negative effect caused by the additional credit risk of a transfer to an entity rated lower than NatWest Bank.
 - Collateralisation would require counterparties to enter into additional collateralisation agreements, put in place systems and controls to accept and safeguard collateral received and to monitor movements and to make payments back to RBS. Not all counterparties will have such systems and controls in place and there would be a cost of putting those in place.

Having considered the issues associated with collateralisation, I am satisfied that RBS's decision not to offer collateralisation is reasonable, especially since RBS will also offer counterparties the ability to terminate the Derivative Transactions at market value or novate to a third party. This would take away future credit risk relating to NatWest Markets if the trades were terminated. Of course the future cash flows could be different (higher or lower for a counterparty) than current expectations and hence this would have to be carefully considered by counterparties. Such a termination may create other issues, such as leaving the counterparty economically unhedged.

I have also considered the fact that any Derivative Transaction, other than Excluded Derivative Transactions, entered into after the opt-out cut-off date will transfer regardless of the nature or type of the Derivative Transaction. As counterparties will be made aware of the future transfer of any Derivative Transaction prior to entering into the trade, I am satisfied that any counterparty

entering into such transactions will be aware of the potential Adverse Effects. Therefore I am satisfied that this is a reasonable course of action for RBS to adopt.

Overall I am satisfied that the Adverse Effect itself is relatively limited when considering the credit risk that currently exists in comparison with the additional credit risk that would be created through the Scheme. As set out above, having considered the actual nature of the Adverse Effect, the need to transfer the Ineligible Derivative Transactions, and the limited ability to transfer the Derivative Transactions into an entity other than one which has a lower rating. I have also considered the advantages and disadvantages of collateralisation and the additional mitigation offered, and the treatment of Derivative Transactions entered into after the opt-out cut-off date. I have concluded that whilst there is an Adverse Effect as a result of the Scheme, I do not consider that this is likely to be greater than is reasonably necessary in order to achieve the relevant purpose of Section 106B(3)(a).

5.3.2.1 Grandfathering Provisions

The ring fencing legislation contains Grandfathering Provisions which permit a RFB to continue to hold certain Ineligible Derivative Transactions if they were entered into prior to 1 January 2019 and mature no later than 31 December 2020. Within the Ineligible Derivative Transactions population, there are certain FX Derivative Transactions ("Ineligible FX Derivative Transactions") that would fall into this category. RBS has decided not to apply the Grandfathering Provisions to Ineligible FX Derivative Transactions which are all being transferred to NatWest Markets. As a result, I have considered whether it is reasonable to transfer Ineligible FX Derivative Transactions maturing no later than 31 December 2020 as part of the Scheme when a decision could have been made to use the Grandfathering Provisions to maintain such Derivative Transactions in NatWest Bank. I have made this assessment in Section 5.3.3 below.

I note that given the short term nature of such Derivative Transactions the effect of any such transfer from a credit risk perspective is reduced. However an effect still remains and I have set out my considerations in respect of the Grandfathering Provisions in Section 5.3.3.1 below.

5.3.3 Hedge accounting

Counterparties will often try to reduce or mitigate the financial effects from risks that could impact upon the counterparty's core business. The counterparty will often enter into Derivative Transaction contracts which will be structured to minimise these risks. For example if a counterparty is obliged to pay a floating interest rate on a loan, it may enter into an interest rate swap whereby it receives payments based on floating interest rates and is obliged to pay a fixed amount thereby economically minimising the risk of interest rate increases in the future. Similarly a counterparty may be required to make payments in a foreign currency and may enter into an FX Derivative Transaction to mitigate against future movements in the foreign currency.

As stated above, the transfer of Derivative Transactions through the Scheme will not change the obligations that RBS and the counterparty have in relation to the Derivative Transactions and therefore from an economic perspective the Derivative Transaction should continue to act as an economic hedge both before and after the Scheme if it was used for such a purpose by the counterparty.

A Derivative Transaction that is an economic hedge may, if appropriate, be treated as a hedge for accounting purposes by a counterparty and if this is achieved, volatility in the profit and loss account may be reduced. However a number of criteria need to be met to achieve hedge accounting. Whilst the transfer of Derivative Transactions through the Scheme does not change the future obligations, the Scheme does result in the RBS entity that is party to the transaction changing to any entity likely to have a lower credit rating. Each counterparty will need to make an assessment in respect of whether, from an accounting perspective, the Derivative Transaction can continue to be treated as an accounting hedge. The accounting standards that govern hedge

accounting are dependent upon the individual circumstances of each counterparty and the effect of a transfer to a lower rated counterparty may be interpreted differently. There is therefore a possibility that this could result in a "break" in hedge accounting treatment, potentially resulting in increased volatility in the financial results of the counterparty. As the accounting interpretation may differ from one counterparty to another, some counterparties may conclude that this does not create an accounting issue, others may conclude that it does.

Whilst this issue may only apply to certain counterparties, as I cannot say that there will be no effect for any counterparty, I have concluded that this is an Adverse Effect of the Scheme and hence I have considered Part b) of the Statutory Question.

5.3.3.1 Consideration of Adverse Effect, including Grandfathering provisions

The potential issue is caused by the transfer of Ineligible Derivative Transactions and the transfer into an entity that has a lower credit rating than NatWest Bank. Overall, as these Ineligible Derivative Transactions cannot remain in the RFB, I am satisfied that a transfer from NatWest Bank is a reasonable course of action. As set out in Section 5.3.2, I am satisfied that a transfer to NatWest Markets is a reasonable course of action in the context of the RBS Group, even if this entity has a lower credit rating than NatWest Bank. RBS has concluded that there is no other action that could reasonably be taken to mitigate the potential accounting issue that may be created for certain counterparties. I concur with this assessment.

In making this assessment I have considered the Grandfathering Provisions within the ring-fencing legislation:

- As set out in Section 5.3.2, the ring fencing legislation contains Grandfathering Provisions which permit the RFB to continue to hold certain Ineligible Derivative Transactions if they were entered into prior to 1 January 2019 and mature no later than 31 December 2020. Within the Ineligible Derivative Transactions population, there are certain Ineligible FX Derivative Transactions that would fall into this category. RBS has decided not to apply these grandfathering provisions to Ineligible FX Derivative Transactions which are all being transferred to NatWest Markets. As a result, I have considered whether it is reasonable to transfer Ineligible FX Derivative Transactions maturing no later than 31 December 2020 as part of the Scheme when a decision could have been made to use the Grandfathering Provisions to maintain such Derivative Transactions in NatWest Bank.

NatWest Markets is currently the main investment banking entity within the RBS Group and the entity where the vast majority of Derivative Transaction trading is performed. This will continue to be the case following the implementation of the ring fencing legislation. NatWest Markets will maintain the operational processes and infrastructure for the Derivative Transactions business post the implementation of the ring fencing legislation and this has been a key determinant in RBS's decision to transfer existing Derivative Transactions to NatWest Markets. Following the implementation of the ring fencing legislation on 1 January 2019, NatWest Bank, as part of the RFB, will not be able to rely on NatWest Markets as the NRFB for operational support and so would need either to maintain its own systems and processes or rely on another entity, such as a service company outside the NRFB in order to book, settle and risk manage transactions. RBS has determined that for Eligible Derivative Transactions (which for these purposes includes grandfathered interest rate Derivative Transactions), such Derivative Transactions can be booked, settled and managed appropriately on existing systems of NatWest Bank and hence will offer counterparties the option not to transfer all their Eligible Derivative Transactions if they so choose in order to mitigate Adverse Effects that may arise on transfer. I have considered this further in Sections 5.4 and 5.5 below.

RBS has stated that for Ineligible FX Derivative Transactions, replicating the required systems and processes in NatWest Bank would be complex. The Ineligible FX Derivative Transactions are more complex in nature than Eligible Derivative Transactions and need different personnel, systems and processes to book, settle and risk manage such transactions. Having considered

the costs, feasibility and risks associated with doing so, I have concluded that RBS's decision to transfer all Ineligible FX Derivative Transactions, including those that could have been grandfathered, through the Scheme is reasonable.

I have also considered the fact that any Derivative Transaction, other than Excluded Derivative Transactions, entered into after the opt-out cut-off date will transfer regardless of the nature or type of the Derivative Transaction. As counterparties will be made aware of the future transfer of any Derivative Transaction prior to entering into the trade, I am satisfied that any counterparty entering into such transactions will be aware of the potential Adverse Effects. Therefore I am satisfied that this is a reasonable course of action for RBS to adopt.

Overall I have concluded that whilst there is an Adverse Effect as a result of the Scheme, I do not consider that this is likely to be greater than is reasonably necessary in order to achieve the relevant purpose of Section 106B(3)(a).

5.3.4 Shared security

Certain customers have granted security to NatWest Bank which covers more than one exposure for example as both security for loans and Derivative Transactions. In the event of default or insolvency of the customer, this security would be enforceable by NatWest Bank with respect to the total amount of the secured exposure. Customers who have provided security on an 'all monies' basis which secures some or all of their liabilities to NatWest Bank, including any Derivative Transactions entered into by them from time to time (which would include any new Derivative Transactions entered into after the Scheme takes effect), but who have no live transactions which will be outstanding after 31 August 2018 are also affected by this change.

Following the Scheme, the total secured exposure of these customers will be split between NatWest Bank and NatWest Markets with, for example, their existing Derivative Transaction (or, if they have no live transactions, their Secured Empty Arrangements) transferring to NatWest Markets but their existing loan remaining in NatWest Bank.

There will be an amendment, under the Scheme, to ensure that such security secures the total exposure for the RBS Group, even if owed to multiple companies after the Scheme, such security to be held by NatWest Bank as trustee for those relevant RBS Group companies. There will also be an inter-creditor agreement which will set out the treatment to be followed between NatWest Bank, NatWest Markets and other relevant RBS Group companies. As a result I have concluded that there is no Adverse Effect on the relevant Stakeholders:

- From a customer perspective, neither the total amount of the security nor the amount owed will change, although it will be owed to a greater number of companies. Whilst there may now be two parties with differing objectives who may exercise these rights, the total amount of the security will not change;
- No significant additional obligations will be imposed on the customer under either the security agreement or the inter-creditor agreement; and
- From the perspective of NatWest Bank and NatWest Markets, their aggregate commercial position will be unchanged before and after the Scheme as they will, between them, have the benefit of the same security for the same exposures (including exposures incurred after the Effective Time which would have been secured by such shared security had the Scheme not taken effect). As between each other, the benefit of such security will be shared proportionately by reference to each entity's secured exposures, and so their proportionate recovery on the security will be unchanged before and after the Scheme, although the inter-creditor agreement will contain some new inter-creditor provisions on arm's length terms as required under ring-fencing legislation.

I have relied upon legal advice provided to RBS in relation to the proposed shared security mechanism.

5.3.5 Set-off rights

5.3.5.1 Customer/ counterparty set-off – additional set-off rights for the RBS Group

A bank set-off right is the right of a bank, in certain circumstances, to apply a liability owed by it to a customer (for instance an obligation to repay money deposited with it, such as in a deposit account) against a debt the same customer owes that becomes repayable, such as under a Derivative Transaction.

There could be situations where, following the Scheme, additional set-off rights are created for NatWest Markets. For example this could occur where before the Scheme, NatWest Bank was owed a debt from a customer and NatWest Markets owed a debt to the customer. Before the Scheme no set-off would generally be available under many statutory insolvency set-off regimes owing to a lack of mutuality. However, following the Effective Date and the implementation of the Scheme, the requisite mutuality would be created whereby set-off of the two claims could be possible in an insolvency of the customer. This could leave NatWest Markets with a set-off right in insolvency following the Scheme, which it otherwise would not have had.

The Scheme Document states that after the Effective Date, for a period of three months, NatWest Markets will not be able to exercise these additional rights, for example to apply money it owes in respect of deposits received against debts transferred to it on Derivative Transaction contracts as a consequence of the Scheme. RBS does not believe any such situations exist but will offer this additional protection as a precaution. The decision to waive these additional rights for three months is in line with precedent in certain other banking business transfer schemes under Part VII of FSMA and the First Scheme. In addition, RBS will also offer the customer a period of three months from the Effective Date to move money, including longer term contracts such as fixed term deposits, without any charge or loss of interest.

As no such positions are thought to exist, and due to the additional protection offered, I have concluded that there is no Adverse Effect as a result of the Scheme.

5.3.5.2 Customer/ counterparty insolvency – loss of set-off rights for the RBS Group

There could be situations where, following the Scheme, the RBS Group has reduced set-off rights in the event of the customer becoming insolvent. For example this could occur in a scenario where NatWest Bank was owed a debt through a loan or mortgage and owed a debt to the same counterparty through a Derivative Transaction contract. In the event of insolvency of the counterparty, the debt owed by NatWest Bank would be offset against the debt owed to NatWest Bank. If through the Scheme the debt owed through the Derivative Transaction transferred to NatWest Markets, NatWest Bank would cease to have the direct benefit of this amount and accordingly lose the ability to make such offsets.

This would not be an Adverse Effect for counterparties being transferred as the debt owed to and from the counterparty would not change. From RBS's perspective, RBS has performed an analysis of those customers in difficulties who also have a Derivative Transaction position where the mark-to-market valuation is in favour of the customer. This analysis shows that the impact of this loss of set-off would be minimal, and as a result I do not consider that there is an Adverse Effect for Stakeholders in this respect.

5.3.5.3 Insolvency or resolution of RBS Group companies – loss of customer set-off rights

There could be situations where following the Scheme, customers lose set-off rights in the event of insolvency or resolution of companies in the RBS Group. For example, pre-Scheme, a customer could have a debt owed by NatWest Bank and a debt owed to NatWest Bank. As a result of the Scheme, a debt owed from NatWest Bank, such as a Derivative Transaction could be transferred to

NatWest Markets whilst the debt owed to NatWest Bank such as a loan or mortgage is not. In the event of insolvency or resolution of NatWest Markets, the customer would still owe the debt to NatWest Bank but may not be able to offset the amount against that owed from NatWest Markets.

I have assessed below situations where customers have contracted for set-off rights and situations where no contractual set-off exists.

Close-out Netting

Under an ISDA Master Agreement positions on multiple Derivative Transactions held between two counterparties may be offset under netting arrangements ("Netting"). A subset of specific transactions between two counterparties may also be established known as a Netting Set. Close-out netting under an ISDA Master Agreement is the process of calculating and netting the termination values of transactions following an event of default or termination event to produce a single amount payable between the parties and this applies with respect to all transactions governed by an ISDA Master Agreement. As Netting Sets will be maintained under the Scheme, I have concluded that there is no Adverse Effect in this respect.

Other contractual set-off

RBS has conducted an analysis which has not identified any such arrangements containing such customer contractual set-off rights. I also note that contractual set-off would only be exercisable in the event of the default of the relevant legal entities, which I do not consider to be probable. As a result, I do not consider that the Scheme would lead to an Adverse Effect.

Non-contractual set-off

Where a customer has no contractual rights of set-off, the general UK insolvency law will still in some circumstances allow or require set-off of reciprocal claims between a customer and an entity. There are equivalent statutory set-off rules in the modified forms of insolvency/resolution proceedings which can also apply to banks under the Banking Act 2009. English statutory insolvency set-off rules rely on the concept of "mutuality". This requires that there have been "mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt" in liquidation or administration. Therefore if the Scheme results in a debt owed by a customer to an entity to be separated from the debt owed from that entity, mutuality would no longer exist.

For there to be a financial detriment to customers in this respect:

- the RBS entity would have to be put into insolvency or resolution;
- the customer would itself still be solvent at the time that the RBS entity defaulted; and
- at the time of the RBS entity default, there would have to be debts owed to that entity from the customer which could have been offset against debts owed from the entity which could have been offset if the Scheme had not occurred.

I do not consider that these events are likely to occur. In particular I note that I do not consider that it is likely that NatWest Markets will be put into insolvency, and in any event since the introduction of the Banking Act 2009, it is likely that other methods (such as the bail-in of liabilities) may be used rather than a traditional insolvency or administration proceeding. In addition I note that many Stakeholders would be considered more likely to default than a regulated bank and also that as at the date of this Scheme Report, in many instances there is no such set-off position as the current value of outstanding Derivative Transaction positions is more often in favour of RBS. I note that this could change in the future.

As well as the above situation being unlikely, I have considered the fact customers did not originally negotiate such express contractual arrangements.

Having taken all these factors into account, I do not consider there to be an Adverse Effect for customers in this respect.

5.3.5.4 All monies

An "all monies" clause allows a mortgage or charge to be used as security for all debts owed to the lender, not just the specific loan or mortgage. A provision has been made in the Scheme Document for such arrangements as, after the Effective Date, all monies clauses in existing NatWest Markets agreements will not apply to debts transferred from NatWest Bank and all monies clauses in agreements transferred from NatWest Bank will not apply to existing debts owed to NatWest Markets or new NatWest Markets debts incurred after the Effective Date (unless the terms on which debts are contracted specifically state that they are so secured). I have therefore concluded that there is no Adverse Effect of the Scheme in this respect.

5.3.5.5 Consolidation rights

A "consolidation clause" permits a lender to retain the security until all debts owed to the lender have been repaid. A provision has been made in the Scheme Document for such arrangements as, after the Effective Date, consolidation clauses in existing NatWest Markets agreements will not apply to prevent the release of the security until all obligations have been satisfied under any obligation transferred from NatWest Bank. Equally consolidation clauses in agreements transferred from NatWest Bank will not apply to prevent the release of the security until all obligations have been satisfied under any existing agreement with NatWest Markets, unless the terms of the agreement permits consolidation between agreements with NatWest Bank and agreements with NatWest Markets. I have therefore concluded that there is no Adverse Effect of the Scheme in this respect.

5.3.5.6 Cross-default

A "cross-default" clause provides for a customer to be automatically in breach of the borrowing or account terms and conditions if in breach of certain other agreements. This may give rise to a right of early termination or a right to demand early repayment of any sum due to the bank. The Scheme Document states that, after the Effective Date, where a customer has products with both NatWest Bank and NatWest Markets, one of which contains a cross-default right, unless it would have done so prior to the Effective Date, a breach of an existing NatWest Markets agreement will not give rise to a breach of any transferred NatWest Bank agreement; and unless it would have done so prior to the Effective Date, a breach of a transferred NatWest Bank agreement will not give rise to a breach of any existing NatWest Markets agreement. I note that the Scheme Document will not restrict cross-default rights where, immediately before the Effective Date, the relevant agreement would treat a breach of an agreement with the other bank as being a breach of that agreement. I have therefore concluded that there is no Adverse Effect of the Scheme in this respect.

5.3.5.7 Payment netting

Payment netting under an ISDA Master Agreement allows the parties on an intra-day basis during the life of a transaction to net amounts payable and receivable on the same day and in the same currency either in respect of the same transaction or two or more transactions. As Netting Sets will be maintained under the Scheme, I have concluded that there is no Adverse Effect in this respect.

5.3.6 Operational and service effects

In respect of operational and service effects:

- The existing contracts and arrangements will transfer as part of the Scheme and there will be no changes to the payments in respect of these contracts with the exception that payments will involve a new account with NatWest Markets after the Effective Date. This will require

counterparties to change Standard Settlement Instructions in respect of payments made in respect of Derivative Transactions (including in respect of associated collateral arrangements). I understand that this is a task which is administrative in nature and so I have concluded that this does not represent an Adverse Effect of the Scheme.

5.3.7 Access to products

New Derivative Transactions entered into after the Effective Date will be made with NatWest Markets rather than NatWest Bank as NatWest Bank will no longer offer such products. Whilst there will be a product curtailment in NatWest Bank this is a strategic decision and is not driven by the Scheme itself and so I do not consider that this is an Adverse Effect of the Scheme. I also note that RBS has stated that all products will continue to be offered by NatWest Markets and so there will be no product curtailment for Derivative Transaction counterparties.

5.3.8 Other contractual provisions

If approved, the Scheme will provide that all references to NatWest Bank will, following the Effective Date, be read as being references to NatWest Markets in the case of business transferring to NatWest Markets. The administrative changes required to allow the transferred business to operate from NatWest Markets following the Effective Date include the following changes as set out in the Scheme Document:

- any reference to NatWest Bank's company registration number, banking license number, country of incorporation, address or other contact details shall be read as reference to NatWest Markets' company registration number, banking license number, address or other contact details;
- any reference to NatWest Bank and all or any of its affiliates shall be construed as a reference to NatWest Markets and such affiliates of NatWest Markets;
- any reference to any director, officer, representative or employee of NatWest Bank shall be construed as a reference to the directors, officers, representatives or employees of NatWest Markets; and
- any reference to a rate, charge, tariff or scale of fees or to terms or conditions of NatWest Bank, or the ability to set or publish such rates, shall be read as references to the same for NatWest Markets.

RBS has undertaken a legal due diligence exercise with respect to the transferring business in order to:

- identify any potential breaches of agreements or contractual rights triggered by the Scheme which, subject to any jurisdictional issues, the Scheme, subject to Court sanction, will override;
- identify the terms of any agreements which the Scheme, subject to Court sanction, will amend to make the relevant agreement work when transferred to NatWest Markets; and
- identify any issues which might form the basis of an objection to the Scheme or which may constitute an Adverse Effect on a customer or Stakeholder.

I have considered the results of the legal due diligence undertaken and overall I have concluded that there is no Adverse Effect. Key issues that I have considered are set out below:

5.3.8.1 Non-UK law

The Scheme operates on the basis of transferring an identified business, such that all assets and liabilities in the transferring business line will transfer pursuant to the Scheme, unless they are expressly carved out as set out in the Scheme Document.

The transferring business includes certain transactions which are wholly or partly governed by a non-UK law. Where these transactions, or any part of them, are governed by a non-UK law which does not recognise the effect of the Scheme, it is intended that the affected non-UK law governed parts of these transactions will be transferred only once any necessary manual transfer and perfection steps have been completed outside the Scheme. This is referred to in the Scheme Document as a "Subsequent Transfer Date".

For example, there are certain transactions where the Derivative Transaction agreement is governed by a UK law but the transaction includes some documents governed by a non-UK law, notably foreign law security. In relation to these transactions, the UK law elements will transfer on the Effective Date with the foreign law elements being classified as a "Residual Asset" or a "Residual Liability" to the extent that the relevant foreign law does not recognise the effect of the Scheme. In this way, an English law governed agreement will transfer to NatWest Markets at the Effective Date but may become "de-linked" from the supporting security, guarantees or other transaction elements which are governed by a non-UK law which will become Residual Assets or Residual Liabilities. Where both the arrangement and the security are governed by a non-UK law, they may transfer at separate times if the necessary manual transfer and perfection steps are completed at different points. These Residual Assets will be held on trust for the benefit of NatWest Markets (or, where such trust is not recognised in the relevant non-UK jurisdiction, NatWest Bank will agree to be subject to a duty to account to NatWest Markets for the Residual Assets or Residual Liabilities). As the security provided by the customer does not change, I do not consider that there is an Adverse Effect from this arrangement.

5.3.8.2 Restrictions on transfer

The legal due diligence has identified a number of contractual provisions which will be overridden through the Scheme's transfer process. These include:

- Restriction on transfers: there are certain contracts where transfers are prohibited; and
- Consent to transfer from counterparty: there are certain contracts where consent to transfer is required from the counterparty.

I also note that certain contracts contain either a requirement to give notice of transfer to the counterparty, or a requirement for consent from either the counterparty or a third party.

These contractual provisions would be overridden if the Scheme were approved and I have taken these into account when reaching my conclusions in respect of Adverse Effects. Where I do not consider that there is an Adverse Effect for transferring counterparties, I do not consider there to be an Adverse Effect for counterparties that have certain rights overridden by the Scheme.

5.3.8.3 Effects of changes in credit rating

The legal due diligence has also identified instances in certain transferring agreements where a transfer to a lower rated counterparty gives rise to termination rights for a counterparty or ongoing obligations on NatWest Markets to take particular action, or a range of possible actions, for example the posting of collateral.

I do not consider that the Scheme has an Adverse Effect in this respect as RBS has elected to preserve the rights such as termination and other enforceable actions that were contractually predetermined. Therefore the counterparty continues to have such rights as a result of the Scheme.

5.3.8.4 ISDA Master Agreement provisions

ISDA Master Agreements generally contain a number of termination provisions, including those which give counterparties the right to terminate contracts when certain requirements are met

(including the occurrence of certain creditworthiness or other credit related events). If these provisions would otherwise be triggered by the circumstances arising from the Scheme, the rights would not be enforceable as a matter of law.

RBS has concluded that there are no such ISDA termination events triggered as a result of transfers that will be effected through the Scheme. I have reviewed RBS's reasons for reaching this conclusion, and based on this review I have concluded there is no Adverse Effect in this respect.

5.3.9 Conclusion

Other than the matter set out in Sections 5.3.2 and 5.3.3, I am satisfied that there are no Adverse Effects as a result of the Scheme in respect of Counterparties with Ineligible Derivative Transactions. In respect of the matter in Sections 5.3.2 and 5.3.3, I am satisfied that the Adverse Effect is not likely to be greater than is reasonably necessary in order to achieve the specific purpose of enabling a UK authorised person to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions (Section 106B(3)(a) of FSMA).

5.4 Counterparties with only Eligible Derivative Transactions

The financial, operational and service effects are very similar to the effects set out in Section 5.3. As a result I have not repeated the full description of the issues in this section but have instead summarised the main elements below. My conclusions in respect of the Adverse Effects identified are however driven by different considerations and I have set these out below:

5.4.1 Contracted rates/fees

The proposed Scheme will not result in any changes to obligations in the Derivative Transaction contracts with no changes to contracted rates and fees. The obligations throughout the life of the contract will not change and the calculation of such obligations will remain unchanged. I therefore do not consider that there is an Adverse Effect in this respect.

5.4.2 Credit risk

Whilst the contracted obligations will not change as a result of the Scheme, open Derivative Transaction contracts are proposed to be transferred from NatWest Bank to NatWest Markets. Counterparties to the Derivative Transactions will therefore contract with a different legal entity following the Scheme. Both entities are regulated banks which have to meet regulatory requirements and as set out in Section 7 RBS's financial projections for NatWest Markets indicate that it will be able to continue to meet minimum regulatory requirements in the future period considered by RBS management. As a result I do not consider that the Scheme results in the Derivative Transaction counterparties being transferred to an entity that is unable to pay its obligations as they fall due.

However whilst NatWest Markets is still expected to be able to pay its obligations as they fall due, there may be other effects on counterparties during the term of the instruments. As set out in Section 3, NatWest Markets will be outside the ring-fenced sub-group and as at the date of this report, the public announcements by the credit rating agencies indicate that it is likely that NatWest Markets will have a lower credit rating than NatWest Bank. For the purpose of my analysis, the credit ratings that have been considered are the long-term unsecured debt ratings, which are typically used by counterparties.

As at the date of this Scheme Report, public announcements^[1] have been made by three credit rating agencies in respect of the ratings of NatWest Bank and NatWest Markets following the restructuring of the RBS Group to comply with ring-fencing rules by 1 January 2019:

- One credit rating agency has stated that the outlook for the credit rating of NatWest Bank is positive and that the outlook for the credit rating of NatWest Markets is stable, which indicates an expectation that at some point in the future NatWest Bank will be rated one notch higher than NatWest Markets;
- One credit rating agency has recently upgraded the credit rating of NatWest Bank by one notch and left the credit rating of NatWest Markets unchanged, resulting in a one notch difference as a result of ring-fencing plans; and
- One credit rating agency has recently upgraded the credit rating of NatWest Bank by one notch and downgraded the credit rating of NatWest Markets by two notches, resulting in a three notch difference as a result of ring-fencing.

It is not clear when all rating changes will be made but it is likely that the Scheme will result in a negative effect for Derivative Transaction counterparties as they are being transferred to an entity which is likely to have a lower credit rating. An effect may arise in relation to the fair valuation of Derivative Transactions that counterparties may record for their financial reporting purposes. Derivative Transactions are generally fair valued for accounting purposes and such valuations

^[1] <http://investors.rbs.com/fixed-income-investors/credit-ratings.aspx>

contain an adjustment that takes into account the risk of default of the entity that is party to the transaction (the "Credit Valuation Adjustment" or "CVA"). There are different methodologies to calculate a CVA but these are often linked to the credit rating of the entity. For example if a Derivative Transaction had a positive fair valuation in the books and records of a counterparty, it may be expected that the fair valuation may be reduced due to the fact the counterparty was, after the Scheme, contracting with a lower rated entity. The Credit Valuation Adjustment in this example would be greater reducing the overall fair valuation. The corresponding entry in the books and records of the counterparty in this case would be to reduce its profits. As noted below, whilst the effect could be limited, it will depend on various factors such as the profile of future exposures, the maturity of the contracts and the CVA methodology used by the counterparty.

Such an effect would not affect all Derivative Transaction counterparties. For example:

- where Derivative Transactions have a positive fair valuation in the books and records of RBS. In such cases there may not be a CVA although I note that fair valuations can change over time and so a Derivative Transaction which currently has a positive fair valuation for RBS could in the future have a positive fair valuation for the counterparty and hence require a CVA.
- Derivative Transaction counterparties which are fully collateralised against the credit risk of RBS will not be affected by this issue as the existence of collateral mitigates the need for a CVA.

I note that the effect on the fair valuation of Derivative Transactions may be limited compared to the effect of changes in other market variables that affect the fair valuation of a Derivative Transaction. Additionally, as set out in the public announcements made to date by the credit rating agencies, the expected difference in the credit ratings of NatWest Bank and NatWest Markets may be up to three notches.

Similarly there may be some effects on Derivative Transaction counterparties that are financially regulated where the transfer of contracts to a lower rated entity results in additional regulatory capital requirements. Again, as set out in the public announcements made to date by the credit rating agencies, the expected difference in the credit ratings of NatWest Bank and NatWest Markets is up to three notches.

As there may be some negative effect on certain counterparties in respect of both fair valuation and regulatory capital, and because I cannot assess whether the effect would be material to these counterparties, I have concluded that the Scheme results in an Adverse Effect for certain Derivative Transaction counterparties. In reaching this conclusion I have considered the fact that counterparties affected by this issue have the ability to opt Eligible Derivative Transactions out of the Scheme. However as customers affected by this issue may nevertheless transfer, I have concluded that there is an Adverse Effect which I need to consider.

I have therefore assessed Part (b) of the Statutory Question:

NatWest Markets is the main Derivative Transaction trading entity of the RBS Group and the entity with which most Derivative Transaction counterparties of the RBS Group already trade. As a result, I have concluded that it is reasonable for Derivative Transactions to be transferred into this entity, rather than for example setting up a completely new entity.

The credit rating of NatWest Markets is influenced by many factors and given the size and nature of the business in the entity, I do not consider that there is a simple action or set of actions that could have been taken to eliminate the difference in credit rating between NatWest Bank and NatWest Markets.

I have also considered the possibility of collateralising the Derivative Transaction exposures:

- Putting two way collateral agreements in place for all transferring counterparties would reduce the effect for counterparties who are owed money by RBS but would result in a financial cost for counterparties who owe a debt to RBS and I do not consider that this would have been a reasonable alternative.

- Putting in place one way collateral agreements whereby only RBS posted collateral would largely eliminate credit risk without a cost for counterparties who owe a debt to RBS. However:
 - Counterparties currently have a credit risk exposure to NatWest Bank through the Derivative Transactions. The introduction of a one way collateral agreement would eliminate this credit risk and hence counterparties would receive a benefit greater than the negative effect caused by the additional credit risk of a transfer to an entity rated lower than NatWest Bank.
 - Collateralisation would require counterparties to enter into additional collateralisation agreements, put in place systems and controls to accept and safeguard collateral received and to monitor movements and to make payments back to RBS. Not all counterparties will have such systems and controls in place and there would be a cost of putting those in place.

Having considered the issues associated with collateralisation, I am satisfied that RBS's decision not to offer collateralisation is reasonable, especially since RBS will offer counterparties the ability to terminate the Derivative Transactions at market value or novate to a third party. This would take away future credit risk relating to NatWest Markets if the trades were terminated. Of course the future cash flows could be different (higher or lower for a counterparty) than current expectations and hence this would have to be carefully considered by counterparties. Such a termination may create other issues, such as leaving the counterparty economically unhedged.

For counterparties whose Derivative Transactions will be transferred as part of the Scheme, having considered the actual nature of the Adverse Effect, the limited ability to transfer the Derivative Transactions into an entity other than one which has a lower rating, the advantages and disadvantages of collateralisation and the additional mitigation offered, I have concluded that the decisions made by RBS in respect of the proposed transfers are reasonable. Overarching this is the fact that RBS will offer counterparties the ability to opt Eligible Derivative Transactions out of the proposed transfer. As a result the Adverse Effects related to the credit risk of NatWest Markets can be avoided by counterparties with only Eligible Derivative Transactions. I have therefore concluded that whilst there is an Adverse Effect as a result of the Scheme, I do not consider that this is likely to be greater than is reasonably necessary in order to achieve the relevant purpose of Section 106B(3)(a).

5.4.3 Hedge accounting

Counterparties will often try to reduce or mitigate the financial effects from risks that could impact upon the counterparty's core business. The counterparty will often enter into Derivative Transaction contracts which will be structured to minimise these risks. For example if a counterparty is obliged to pay a floating interest rate on a loan, it may enter into an interest rate swap whereby it receives payments based on floating interest rates and is obliged to pay a fixed amount thereby economically minimising the risk of interest rate increases in the future. Similarly a counterparty may be required to make payments in a foreign currency and may enter into a FX Derivative Transaction to mitigate against future movements in the foreign currency.

As stated above, the transfer of Derivative Transactions through the Scheme will not change the obligations that RBS and the counterparty have in relation to the Derivative Transactions and therefore from an economic perspective the Derivative Transaction should continue to act as an economic hedge both before and after the Scheme if it was used for such a purpose by the counterparty.

A Derivative Transaction that is an economic hedge may, if appropriate, be treated as a hedge for accounting purposes by a counterparty and if this is achieved, volatility in the profit and loss account may be reduced. However a number of criteria need to be met to achieve hedge accounting. Whilst the transfer of Derivative Transactions through the Scheme does not change the future obligations, the Scheme does result in the RBS entity that is party to the transaction changing to an entity likely to have a lower credit rating. Each counterparty will need to make an assessment in respect of whether, from an accounting perspective, the Derivative Transaction can continue to be treated as an accounting hedge. The accounting standards that govern hedge

accounting are dependent upon the individual circumstances of each counterparty and the effect of a transfer to a lower rated counterparty may be interpreted differently. There is therefore a possibility that this could result in a "break" in hedge accounting treatment, potentially resulting in increased volatility in the financial results of the counterparty. As the accounting interpretation may differ from one counterparty to another, some counterparties may conclude that this does not create an accounting issue, others may conclude that it does.

Whilst this issue may only apply to certain counterparties, as I cannot say that there will be no effect for any counterparty, I have concluded that this is an Adverse Effect of the Scheme. In reaching this conclusion I have considered the fact that counterparties affected by this issue have the ability to opt Eligible Derivative Transactions out of the Scheme. However as counterparties affected by this issue may nevertheless transfer, I have concluded that there is an Adverse Effect which I need to consider. I have therefore considered Part b) of the Statutory Question.

The hedge accounting issue may only apply to certain counterparties. As RBS will offer counterparties the opportunity for Eligible Derivative Transactions not to be transferred as part of the Scheme, counterparties have the ability to avoid this Adverse Effect if they choose. For this reason, whilst I have concluded that there is an Adverse Effect as a result of the Scheme, I do not consider that this is likely to be greater than is reasonably necessary in order to achieve the relevant purpose of Section 106B(3)(a).

5.4.4 Shared security

Certain customers have granted security to NatWest Bank which covers more than one exposure, for example as both security for loans and Derivative Transactions. In the event of default or insolvency of the customer, this security would be enforceable by NatWest Bank with respect to the total amount of the secured exposure. Customers who have provided security on an 'all monies' basis which secures some or all of their liabilities to NatWest Bank, including any Derivative Transactions entered into by them from time to time (which would include any new Derivative Transactions entered into after the Scheme takes effect), but who have no live transactions which will be outstanding after 31 August 2018 are also affected by this change.

Following the Scheme, the total secured exposure of these customers will be split between NatWest Bank and NatWest Markets with, for example, their existing Derivative Transaction (or, if they have no live transactions, their Secured Empty Arrangements) transferring to NatWest Markets but their existing loan remaining in NatWest Bank.

There will be an amendment, under the Scheme, to ensure that such security secures the total exposure for the RBS Group, even if owed to multiple companies after the Scheme, such security to be held by NatWest Bank as trustee for those relevant RBS Group companies. There will also be an inter-creditor agreement which will set out the treatment to be followed between NatWest Bank, NatWest Markets and other relevant RBS Group companies.

For the reasons set out in Section 5.3.4, I have concluded that there is no Adverse Effect in this respect.

5.4.5 Set-off rights

I have considered the effect of the Scheme on set-off rights, which include:

5.4.5.1 Customer/Counterparty set-off – additional set-off rights for the RBS Group

A bank set-off right is the right of a bank, in certain circumstances, to apply a liability owed by it to a customer for instance an obligation to repay money deposited with it, such as in a deposit account, against a debt the same customer owes that becomes repayable, such as under a Derivative Transaction.

There could be situations where, following the Scheme, additional set-off rights are created for NatWest Markets. For example this could occur where before the Scheme, NatWest Bank was owed a debt from a customer and NatWest Markets owed a debt to the customer. Before the Scheme no set-off would generally be available under many statutory insolvency set-off regimes owing to a lack of mutuality. However, following the Effective Date and the implementation of the Scheme, the requisite mutuality would be created whereby set-off of the two claims could be possible in an insolvency of the customer. This could leave NatWest Markets with a set-off right in insolvency following the Scheme, which it otherwise would not have had.

The Scheme Document states that after the Effective Date, for a period of three months, NatWest Markets will not be able to exercise these additional rights, for example to apply money it owes in respect of deposits received against debts transferred to it on Derivative Transaction contracts as a consequence of the Scheme. RBS does not believe any such situations exist but will offer this additional protection as a precaution. The decision to waive these additional rights for three months is in line with precedent in certain other banking business transfer schemes under Part VII of FSMA and the First Scheme. In addition, RBS will also offer the customer a period of three months from the Effective Date to move money, including longer term contracts such as fixed term deposits, without any charge or loss of interest.

As no such positions are thought to exist, and due to the additional protection offered, I have concluded that there is no Adverse Effect as a result of the Scheme.

5.4.5.2 Customer/ counterparty insolvency – loss of set-off rights for the RBS Group

There could be situations where, following the Scheme, the RBS Group has reduced set-off rights in the event of the customer becoming insolvent. For example this could occur in a scenario where NatWest Bank was owed a debt through a loan or mortgage and owed a debt to the same counterparty through a Derivative Transaction contract. In the event of insolvency of the counterparty, the debt owed by NatWest Bank would be offset against the debt owed to NatWest Bank. If through the Scheme the debt owed through the Derivative Transaction transferred to NatWest Markets, NatWest Bank would cease to have the direct benefit of this amount and accordingly, lose the ability to make such offsets.

This would not be an Adverse Effect for counterparties being transferred as the debt owed to and from the counterparty would not change. From RBS's perspective, RBS has performed an analysis of those customers in difficulties who also have a Derivative Transaction position where the mark-to-market valuation is in favour of the customer. This analysis shows that the impact of this loss of set-off would be minimal, and as a result I do not consider that there is an Adverse Effect for other Stakeholders in this respect.

5.4.5.3 Insolvency or resolution of RBS Group companies – loss of customer set-off rights

Close-out Netting

Close-out netting under an ISDA Master Agreement is the process of calculating and netting the termination values of transactions following an event of default or termination event to produce a single amount payable between the parties and this applies with respect to all transactions governed by an ISDA Master Agreement. If all Eligible Derivative Transactions are transferred, these Netting Sets will be maintained under the Scheme and therefore, I have concluded that there is no Adverse Effect in this respect.

Other contractual set-off

RBS has conducted an analysis which has not identified any such arrangements containing such customer contractual set-off rights. I also note that contractual set-off would only be exercisable in

the event of the default of the relevant legal entities, which I do not consider to be probable. As a result, I do not consider that the Scheme would lead to an Adverse Effect.

Non-contractual set-off

Where a customer has no contractual rights of set-off, the general UK insolvency law will still in some circumstances allow or require set-off of reciprocal claims between a customer and an entity. There are equivalent statutory set-off rules in the modified forms of insolvency/resolution proceedings which can also apply to banks under the Banking Act 2009. English statutory insolvency set-off rules rely on the concept of "mutuality". This requires that there have been "mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt" in liquidation or administration. Therefore if the Scheme results in a debt owed by a customer to an entity to be separated from the debt owed from that entity, mutuality would no longer exist.

For there to be a financial detriment to customers in this respect:

- the RBS entity would have to be put into insolvency or resolution;
- the customer would itself still be solvent at the time that the RBS entity defaulted; and
- at the time of the RBS entity default, there would have to be debts owed to that entity from the customer which could have been offset against debts owed from the entity which could have been offset if the Scheme had not occurred.

I do not consider that these events are likely to occur. In particular I note that I do not consider that it is likely that NatWest Markets will be put into insolvency, and in any event since the introduction of the Banking Act 2009, it is likely that other methods (such as the bail-in of liabilities) may be used rather than a traditional insolvency or administration proceeding. In addition I note that many Stakeholders would be considered more likely to default than a regulated bank and also that as at the date of this Scheme Report, in many instances there is no such set-off position as the current value of outstanding Derivative Transaction positions is more often in favour of RBS. I note that this could change in the future.

As well as the above situation being unlikely, I have considered the fact customers did not originally negotiate such express contractual arrangements.

Having taken all these factors into account, I do not consider there to be an Adverse Effect for customers in this respect.

5.4.5.4 Windfall rights

As set out in Section 5.3.5, the transfer of Derivative Transactions through the Scheme could affect rights such as:

- All monies
- Consolidation rights
- Cross default rights

Provisions have been made in the Scheme Document for such arrangements and as a result, as set out in Section 5.3.5, I have concluded that there are no Adverse Effects as a result of the Scheme.

5.4.5.5 Payment netting

Payment netting under an ISDA Master Agreement allows the parties on an intra-day basis during the life of a transaction to net amounts payable and receivable on the same day and in the same currency either in respect of the same transaction or two or more transactions. As Netting Sets will be maintained under the Scheme, I have concluded that there is no Adverse Effect in this respect.

5.4.6 Operational and service effects

In respect of operational and service effects:

- The existing contracts and arrangements will transfer as part of the Scheme and there will be no changes to the payments in respect of these contracts with the exception that payments will involve a new account with NatWest Markets after the Effective Date. This will require counterparties to change Standard Settlement Instructions in respect of payments made in respect of Derivative Transactions (including in respect of associated collateral arrangements). I understand that this is a task which is administrative in nature and so I have concluded that this does not represent an Adverse Effect of the Scheme.

5.4.7 Access to products

New Derivative Transactions entered into after the Effective Date will be made with NatWest Markets rather than NatWest Bank as NatWest Bank will no longer offer such products. Whilst there will be a product curtailment in NatWest Bank this is a strategic decision and is not driven by the Scheme itself and so I do not consider that this is an Adverse Effect of the Scheme. I also note that RBS has stated that all products will continue to be offered by NatWest Markets and so there will be no product curtailment for Derivative Transaction counterparties.

5.4.8 Other contractual provisions

As set out in Section 5.3.8, if approved, certain administrative changes will be made by the Scheme in order to allow the transferred business to operate from NatWest Markets following the Effective Date. As set out in Section 5.3.8, I understand that these are administrative in nature and do not represent Adverse Effects.

RBS has undertaken a legal due diligence exercise with respect to the transferring business in order to:

- identify any potential breaches of agreements or contractual rights triggered by the Scheme which, subject to any jurisdictional issues, the Scheme, subject to Court sanction, will override;
- identify the terms of any agreements which the Scheme, subject to Court sanction, will amend to make the relevant agreement work when transferred to NatWest Markets; and
- identify any issues which might form the basis of an objection to the Scheme or which may constitute an Adverse Effect on a customer or Stakeholder.

I have considered the results of the legal due diligence undertaken and overall I have concluded that there is no Adverse Effect. Key issues that I have considered are set out below:

5.4.8.1 Non-UK law

As set out in Section 5.3.8.1, I do not consider that there is an Adverse Effect of the Scheme.

5.4.8.2 Restrictions on transfer

The legal due diligence has identified a number of contractual provisions which will be overridden through the Scheme's transfer process. These include:

- Restriction on transfers: there are certain contracts where transfers are prohibited; and
- Consent to transfer from counterparty: there are certain contracts where consent to transfer is required from the counterparty.

I also note that certain contracts contain either a requirement to give notice of transfer to the counterparty, or a requirement for consent from either the counterparty or a third party.

These contractual provisions would be overridden if the Scheme were approved and I have taken these into account when reaching my conclusions in respect of Adverse Effects. Where I do not consider there is an Adverse Effect for transferring counterparties, I do not consider there to be an Adverse Effect for counterparties that have certain rights overridden by the Scheme.

5.4.8.3 Effects of changes in credit rating

The legal due diligence has also identified instances in certain transferring agreements where a transfer to a lower rated counterparty gives rise to termination rights for a counterparty or ongoing obligations on NatWest Markets to take particular action (or a range of possible actions), for example the posting of collateral. As set out in Section 5.3.8.3, I do not consider that the Scheme creates an Adverse Effect in this respect as RBS has elected to preserve the rights (e.g. termination and other enforceable actions) that were contractually predetermined. Therefore the counterparty continues to have such rights as a result of the Scheme.

5.4.8.4 ISDA Master Agreement provisions

ISDA Master Agreements generally contain a number of termination provisions, including those which give counterparties the right to terminate contracts when certain requirements are met (including the occurrence of certain creditworthiness or other credit related events). If these provisions would otherwise be triggered by the circumstances arising from the Scheme, the rights would not be enforceable as a matter of law.

RBS has concluded that there are no such ISDA termination events triggered as a result of transfers that will be effected through the Scheme. As set out in Section 5.3, I have reviewed RBS's reasons for reaching this conclusion, and based on this review I have concluded there is no Adverse Effect in this respect.

5.4.9 Option not to transfer Derivative Transactions

In this report, I have sought to identify whether the proposed transfers under the Scheme would create Adverse Effects and whether these, where identified, were greater than reasonably necessary to achieve the relevant purpose of Section 106B(3)(a). I have set out in my Scheme Report my conclusions in this respect.

RBS will offer counterparties an option to "leave behind" Eligible Derivative Transactions in NatWest Bank. Whilst I have considered if a counterparty may suffer Adverse Effects as a result of the Scheme, I have not considered whether the option to leave their Derivative Transactions in NatWest Bank would result in a better outcome for that counterparty than the transfer of their Derivative Transactions. I do not know the particular facts and circumstances of each counterparty and hence I am not able to determine which course of action a counterparty should follow. My Report does not make this determination.

For example, my report only considers existing contractual relationships and the effects of the Scheme. A consideration for a counterparty may be the level of new trading that it may perform following the Effective Date of the Scheme. RBS has made a strategic decision to execute new Derivative Transaction trading in NatWest Markets only following the Effective Date. If a counterparty therefore decides to execute a new Derivative Transaction trade with RBS following the Effective Date this will be with NatWest Markets. If a counterparty determines that existing Derivative Transactions should not be transferred as part of the Scheme and should remain with NatWest Bank, this could have consequences in the future such as the fact that in the future the counterparty will have relationships with two banks and netting of payments may not be possible between the different banks. This may be seen by the counterparty to be negative but is not

caused by the Scheme as (at the request of the counterparty) the existing contracts in this set of circumstances are not part of the Scheme and it is the new trading activity and the strategic decision by RBS only to perform such activity in NatWest Markets that causes this effect. It may be an important consideration for the counterparty in determining whether Derivative Transactions should not be transferred as part of the Scheme.

A counterparty should consider its particular facts and circumstances and this is not something I have sought to do here. As the ability exists for counterparties not to be part of the Scheme and hence their position would be unchanged, I have concluded that this a reasonable course of action for RBS to take.

5.4.10 Conclusion

Other than the matter set out in Sections 5.4.2 and 5.4.3, I am satisfied that there are no Adverse Effects as a result of the Scheme in respect of Counterparties with Eligible Derivative Transactions. In respect of the matter in Sections 5.4.2 and 5.4.3, I am satisfied that the Adverse Effect is not likely to be greater than is reasonably necessary in order to achieve the specific purpose of enabling a UK authorised person to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions (Section 106B(3)(a) of FSMA).

5.5 Counterparties with both Ineligible Derivative Transactions and Eligible Derivative Transactions

The financial, operational and service effects are very similar to the effects set out in Section 5.3. As a result I have not repeated the full description of the issues in this section but have instead summarised the main elements below. My conclusions in respect of the Adverse Effects identified are however driven by different considerations and I have set these out below:

5.5.1 Contracted rates/fees

The proposed Scheme will not result in any changes to obligations in the Derivative Transaction contracts with no changes to contracted rates and fees. The obligations throughout the life of the contract will not change and the calculation of such obligations will remain unchanged. I therefore do not consider that there is an Adverse Effect in this respect.

5.5.2 Credit risk

Whilst the contracted obligations will not change as a result of the Scheme, open Derivative Transaction contracts are proposed to be transferred from NatWest Bank to NatWest Markets. Counterparties to the Derivative Transactions will therefore contract with a different legal entity following the Scheme. Both entities are regulated banks which have to meet regulatory requirements and as set out in Section 7, RBS's financial projections for NatWest Markets indicate that it will be able to continue to meet minimum regulatory requirements in the future period considered by RBS management. As a result I do not consider that the Scheme results in the Derivative Transaction counterparties being transferred to an entity that is unable to pay its obligations as they fall due.

However whilst NatWest Markets may be able to pay its obligations as they fall due, there may be other effects on counterparties during the term of the instruments. As set out in Section 3, NatWest Markets will be outside the ring-fenced sub-group and as at the date of this report, the public announcements by the credit rating agencies indicate that it is likely that NatWest Markets will have a credit rating lower than NatWest Bank. For the purpose of my analysis, the credit ratings that have been considered are the long-term unsecured debt ratings, which are typically used by counterparties.

As at the date of this Scheme Report, public announcements^[1] have been made by three credit rating agencies in respect of the ratings of NatWest Bank and NatWest Markets following the restructuring of the RBS Group to comply with ring-fencing rules by 1 January 2019:

- One credit rating agency has stated that the outlook for the credit rating of NatWest Bank is positive and that the outlook for the credit rating of NatWest Markets is stable, which indicates an expectation that at some point in the future NatWest Bank will be rated one notch higher than NatWest Markets;
- One credit rating agency has recently upgraded the credit rating of NatWest Bank by one notch and left the credit rating of NatWest Markets unchanged, resulting in a one notch difference as a result of ring-fencing plans; and
- One credit rating agency has recently upgraded the credit rating of NatWest Bank by one notch and downgraded the credit rating of NatWest Markets by two notches, resulting in a three notch difference as a result of ring-fencing.

It is not clear when all rating changes will be made but it is likely that the Scheme will result in a negative effect for Derivative Transaction counterparties as they are being transferred to an entity which is likely to have a lower credit rating. An effect may arise in relation to the fair valuation of Derivative Transactions that counterparties may record for their financial reporting purposes.

^[1] <http://investors.rbs.com/fixed-income-investors/credit-ratings.aspx>

Derivative Transactions are generally fair valued for accounting purposes and such valuations contain an adjustment that takes into account the risk of default of the entity that is party to the transaction (the "Credit Valuation Adjustment" or "CVA"). There are different methodologies to calculate a CVA but these are often linked to the credit rating of the entity. For example if a Derivative Transaction had a positive fair valuation in the books and records of a counterparty, it may be expected that the fair valuation may be reduced due to the fact the counterparty was, after the Scheme, contracting with a lower rated entity. The Credit Valuation Adjustment in this example would be greater reducing the overall fair valuation. The corresponding entry in the books and records of the counterparty in this case would be to reduce its profits. As noted below, whilst the effect could be limited, it will depend on various factors such as the profile of future exposures, the maturity of the contracts and the CVA methodology used by the counterparty.

Such an effect would not affect all Derivative Transaction counterparties. For example:

- where Derivative Transactions have a positive fair valuation in the books and records of RBS. In such cases there may not be a CVA although I note that fair valuations can change over time and so a Derivative Transaction which currently has a positive fair valuation for RBS could in the future have a positive fair valuation for the counterparty and hence require a CVA.
- Derivative Transaction counterparties which are fully collateralised against the credit risk of RBS will not be affected by this issue as the existence of collateral mitigates the need for a CVA.

I note that the effect on the fair valuation of Derivative Transactions may be limited compared to the effect of changes in other market variables that affect the fair valuation of a Derivative Transaction. Additionally, as set out in the public announcements made to date by the credit rating agencies, the expected difference in the credit ratings of NatWest Bank and NatWest Markets may be up to three notches.

Similarly there may be some effect on Derivative Transaction counterparties that are financially regulated where the transfer of contracts to a lower rated entity results in additional regulatory capital requirements. Again, as set out in the public announcements made to date by the credit rating agencies, the expected difference in the credit ratings of NatWest Bank and NatWest Markets is up to three notches.

As there may be some negative effects on certain counterparties in respect of both fair valuation and regulatory capital, and because I cannot assess whether the effect would be material to these counterparties, I have concluded that the Scheme results in an Adverse Effect for certain Derivative Transaction counterparties.

I have therefore assessed Part b) of the Statutory Question. The key issues I have taken into account in reaching my conclusions are set out below:

5.5.2.1 Ineligible Derivative Transactions

Ineligible Derivative Transactions cannot remain in the RFB. Therefore there is a need to transfer the Derivative Transactions from NatWest Bank. I have therefore considered whether the transfers could have been made to another entity or in a manner which prevented any additional credit risk:

- NatWest Markets is the main Derivative Transaction trading entity of the RBS Group and the entity with which most Derivative Transaction counterparties of the RBS Group already trade. As a result, I have concluded that it is reasonable for Derivative Transactions to be transferred into this entity, rather than for example setting up a completely new entity.
- The credit rating of NatWest Markets is influenced by many factors and given the size and nature of the business in the entity, I do not consider that there is a simple action or set of actions that could have been taken to eliminate the difference in credit rating between NatWest Bank and NatWest Markets.

I have also considered the possibility of collateralising the Derivative Transaction exposures:

- Putting two way collateral agreements in place for all transferring counterparties would reduce the effect for counterparties who are owed money by RBS but would result in a financial cost for counterparties who owe a debt to RBS and I do not consider that this would have been a reasonable alternative.
- Putting in place one way collateral agreements whereby only RBS posted collateral would largely eliminate credit risk without a cost for counterparties who owe a debt to RBS. However:
 - Counterparties currently have a credit risk exposure to NatWest Bank through the Derivative Transactions. The introduction of a one way collateral agreement would eliminate this credit risk and hence counterparties would receive a benefit greater than the negative effect caused by the additional credit risk of a transfer to an entity rated lower than NatWest Bank.
 - Collateralisation would require counterparties to enter into additional collateralisation agreements, put in place systems and controls to accept and safeguard collateral received and to monitor movements and to make payments back to RBS. Many of the counterparties are unlikely to have such systems and controls in place and there would be a cost of putting this in place.

Having considered the issues associated with collateralisation, I am satisfied that RBS's decision not to offer collateralisation is reasonable, especially since RBS will also offer counterparties the ability to terminate the Derivative Transactions at market value or novate to a third party. This would take away future credit risk relating to NatWest Markets if the trades were terminated. Of course the future cash flows could be different (higher or lower for a counterparty) than current expectations and hence this would have to be carefully considered by counterparties. Such a termination may create other issues, such as leaving the counterparty economically unhedged.

I have also considered the fact that any Derivative Transaction, other than Excluded Derivative Transactions, entered into after the opt-out cut-off date will transfer regardless of the nature or type of the Derivative Transaction. As counterparties will be made aware of the future transfer of any Derivative Transaction prior to entering into the trade, I am satisfied that any counterparty entering into such transactions will be aware of the potential Adverse Effects. Therefore I am satisfied that this is a reasonable course of action for RBS to adopt.

Overall I am satisfied that the Adverse Effect itself is relatively limited when considering the credit risk that currently exists in comparison with the additional credit risk that would be created through the Scheme. As set out above, having considered the actual nature of the Adverse Effect, the need to transfer the Ineligible Derivative Transactions, the limited ability to transfer the Derivative Transactions into an entity other than one which has a lower rating, the advantages and disadvantages of collateralisation and the additional mitigation offered, I have concluded that whilst there is an Adverse Effect as a result of the Scheme, I do not consider that this is likely to be greater than is reasonably necessary in order to achieve the relevant purpose of Section 106B(3)(a).

5.5.2.2 Grandfathering Provisions

The ring fencing legislation contains Grandfathering Provisions which permit the RFB to continue to hold certain Ineligible Derivative Transactions if they were entered into prior to 1 January 2019 and mature no later than 31 December 2020. Within the Ineligible Derivative Transactions population, there are certain Ineligible FX Derivative Transactions that would fall into this category. RBS has decided not to apply these Grandfathering Provisions to Ineligible FX Derivative Transactions which are all being transferred to NatWest Markets. As a result, I have considered whether it is reasonable to transfer Ineligible FX Derivative Transactions maturing no later than 31 December 2020 as part of the Scheme when a decision could have been made to use the Grandfathering Provisions to maintain such Derivative Transactions in NatWest Bank

I have made this assessment in Section 5.3.3.1. I note that given the short term nature of such Derivative Transactions the effect of any such transfer from a credit risk perspective is reduced.

However an effect still remains and I have set out my considerations in respect of the Grandfathering Provisions in Section 5.3.3.1.

5.5.2.3 Eligible Derivative Transactions

In respect of Eligible Derivative Transactions, in reaching my conclusion that there is an Adverse Effect, I have considered the fact that counterparties affected by this issue have the ability to opt Eligible Derivative Transactions out of the Scheme. However as customers affected by this issue may nevertheless transfer, I have concluded that there is an Adverse Effect which I need to consider. I have therefore considered Part (b) of the Statutory Question.

In this respect, having considered the actual nature of the Adverse Effect, the limited ability to transfer the Derivative Transactions into an entity other than one which has a lower rating, the advantages and disadvantages of collateralisation and the additional mitigation offered, I have concluded that the decisions made by RBS in respect of the proposed transfers are reasonable. Overarching this is the fact that RBS will offer counterparties the ability to opt Eligible Derivative Transactions out of the proposed transfer. As a result the Adverse Effects related to the credit risk of NatWest Markets can be avoided by counterparties in respect of the Eligible Derivative Transactions within the Scheme.

I note that should a counterparty choose not to transfer Eligible Derivative Transactions, there will be other implications to consider as a result of their portfolio being split across NatWest Bank and NatWest Markets. This is discussed in Section 5.5.7 and 5.5.10.

5.5.2.4 Conclusion

For counterparties whose Derivative Transactions will be transferred as part of the Scheme, having considered the actual Adverse Effect, the requirement to transfer Ineligible Derivative Transactions, the limited ability to transfer the Derivative Transactions into an entity other than one which has a lower rating, the advantages and disadvantages of collateralisation and the additional mitigation offered, in particular the ability for counterparties to choose not to transfer Eligible Derivative Transactions, I have concluded that the decisions made by RBS in respect of the proposed transfers are reasonable.

I have therefore concluded that whilst there is an Adverse Effect as a result of the Scheme, I do not consider that this is likely to be greater than is reasonably necessary in order to achieve the relevant purpose of Section 106B(3)(a).

5.5.3 Hedge accounting

Counterparties will often try to reduce or mitigate the financial effects from risks that could impact upon the counterparty's core business. The counterparty will often enter into Derivative Transaction contracts which will be structured to minimise these risks. For example if a counterparty is obliged to pay a floating interest rate on a loan, it may enter into an interest rate swap whereby it receives payments based on floating interest rates and is obliged to pay a fixed amount thereby economically minimising the risk of interest rate increases in the future. Similarly a counterparty may be required to make payments in a foreign currency and may enter into a FX Derivative Transaction to mitigate against future movements in the foreign currency.

As stated above, the transfer of Derivative Transactions through the Scheme will not change the obligations that RBS and the counterparty have in relation to the Derivative Transactions and therefore from an economic perspective the Derivative Transaction should continue to act as an economic hedge both before and after the Scheme if it was used for such a purpose by the counterparty.

A Derivative Transaction that is an economic hedge may, if appropriate, be treated as a hedge for accounting purposes by a counterparty and if this is achieved, volatility in the profit and loss account may be reduced. However a number of criteria need to be met to achieve hedge accounting. Whilst the transfer of Derivative Transactions through the Scheme does not change the future obligations, the Scheme does result in the RBS entity that is party to the transaction changing to an entity likely to have a lower credit rating. Each counterparty will need to make an assessment in respect of whether, from an accounting perspective, the Derivative Transaction can continue to be treated as an accounting hedge. The accounting standards that govern hedge accounting are dependent upon the individual circumstances of each counterparty and the effect of a transfer to a lower rated counterparty may be interpreted differently. There is therefore a possibility that this could result in a "break" in hedge accounting treatment, potentially resulting in increased volatility in the financial results of the counterparty. As the accounting interpretation may differ from one counterparty to another, some counterparties may conclude that this does not create an accounting issue, others may conclude that it does.

Whilst this issue may only apply to certain counterparties, as I cannot say that there will be no effect for any counterparty, I have concluded that this is an Adverse Effect of the Scheme and hence I have considered Part b) of the Statutory Question.

5.5.3.1 Ineligible Derivative Transactions

Overall, as Ineligible Derivative Transactions cannot remain in the RFB, I am satisfied that a transfer to NatWest Markets is a reasonable course of action in the context of the RBS Group, even if this entity has a lower credit rating than NatWest Bank. RBS has concluded that there is no other action that could reasonably be taken to mitigate the potential accounting issue that may be created for certain counterparties. I concur with this assessment.

In making this assessment I have considered the Grandfathering Provisions within the ring-fencing legislation:

- The ring fencing legislation contains Grandfathering Provisions which permit the RFB to continue to hold certain Ineligible Derivative Transactions if they were entered into prior to 1 January 2019 and mature no later than 31 December 2020. Within the Ineligible Derivative Transactions population, there are certain Ineligible FX Derivative Transactions that would fall into this category. RBS has decided not to apply these grandfathering provisions to Ineligible FX Derivative Transactions which are all being transferred to NatWest Markets. As a result, I have considered whether it is reasonable to transfer Ineligible FX Derivative Transactions maturing no later than 31 December 2020 as part of the Scheme when a decision could have been made to use the Grandfathering Provisions to maintain such Derivative Transactions in NatWest Bank.

NatWest Markets is currently the main investment banking entity within the RBS Group and the entity where the vast majority of Derivative Transaction trading is performed and this will continue to be the case following the implementation of the ring fencing legislation. NatWest Markets will maintain the operational processes and infrastructure for the derivative business following the implementation of the ring fencing legislation and this has been a key determinant in RBS's decision to transfer existing Derivative Transactions to NatWest Markets. Following the implementation of the ring fencing legislation on 1 January 2019, NatWest Bank, as an RFB will not be able to rely on NatWest Markets as the NRFB for operational support and so would need either to maintain its own systems and processes or rely on another entity, such as a service company, outside the NRFB in order to book, settle and risk manage transactions. RBS has determined that for Eligible Derivative Transactions (which for these purposes includes grandfathered interest rate Derivative Transactions), such Derivative Transactions can be booked, settled and managed appropriately on existing systems of NatWest Bank and hence will offer counterparties the option not to transfer all their Eligible Derivative Transactions if they so choose in order to mitigate Adverse Effects that may arise on transfer.

RBS has stated that for Ineligible FX Derivative Transactions, replicating the required systems and processes in NatWest Bank would be complex. The Ineligible FX Derivative Transactions are more complex in nature than Eligible Derivative Transactions and need different personnel, systems and processes to book, settle and risk manage such transactions. Having considered the costs, feasibility and risks associated with doing so, I have concluded that RBS's decision to transfer all Ineligible FX Derivative Transactions, including those that could have been grandfathered, through the Scheme is reasonable.

I have also considered the fact that any Derivative Transaction, other than Excluded Derivative Transactions, entered into after the opt-out cut-off date will transfer regardless of the nature or type of the Derivative Transaction. As counterparties will be made aware of the future transfer of any Derivative Transaction prior to entering into the trade, I am satisfied that any counterparty entering into such transactions will be aware of the potential Adverse Effects. Therefore I am satisfied that this is a reasonable course of action for RBS to adopt.

5.5.3.2 Eligible Derivative Transactions

In respect of Eligible Derivative Transactions, in reaching my conclusion that there is an Adverse Effect, I have considered the fact that counterparties affected by this issue have the ability to opt Eligible Derivative Transactions out of the Scheme. However as counterparties affected by this issue may nevertheless transfer, I have concluded that there is an Adverse Effect which I need to consider.

The hedge accounting issue may only apply to certain counterparties. As RBS will offer counterparties the opportunity for Eligible Derivative Transactions not to be transferred as part of the Scheme, counterparties have the ability to avoid this Adverse Effect if they choose, although as discussed in 5.5.7 and 5.5.10 it should be noted that there are other consequences of doing so that should be considered by such counterparties. For this reason, whilst I have concluded that there is an Adverse Effect as a result of the Scheme, I do not consider that this is likely to be greater than is reasonably necessary in order to achieve the relevant purpose of Section 106B(3)(a).

5.5.3.3 Conclusion

Overall I have concluded that whilst there is an Adverse Effect as a result of the Scheme, I do not consider that this is likely to be greater than is reasonably necessary in order to achieve the relevant purpose of Section 106B(3)(a).

5.5.4 Shared security

Certain customers have granted security to NatWest Bank which covers more than one exposure, for example as both security for loans and Derivative Transactions. In the event of default or insolvency of the customer, this security would be enforceable by NatWest Bank with respect to the total amount of the secured exposure. Customers who have provided security on an 'all monies' basis which secures some or all of their liabilities to NatWest Bank, including any Derivative Transactions entered into by them from time to time (which would include any new Derivative Transactions entered into after the Scheme takes effect), but who have no live transactions which will be outstanding after 31 August 2018 are also affected by this change.

Following the Scheme, the total secured exposure of these customers will be split between NatWest Bank and NatWest Markets with, for example, their existing Derivative Transaction (or, if they have no live transactions, their Secured Empty Arrangements) transferring to NatWest Markets but their existing loan remaining in NatWest Bank.

There will be an amendment, under the Scheme, to ensure that such security secures the total exposure for the RBS Group, even if owed to multiple companies after the Scheme, such security

to be held by NatWest Bank as trustee for those relevant RBS Group companies. There will be an inter-creditor agreement which will set out the treatment to be followed between NatWest Bank, NatWest Markets and other relevant RBS Group companies.

For the reasons set out in Section 5.3.4, I have concluded that there is no Adverse Effect in this respect.

5.5.5 Set-off rights

I have considered the effect of the Scheme on set-off rights, which include:

5.5.5.1 Customer/Counterparty set-off – additional set-off rights for the RBS Group

A bank set-off right is the right of a bank, in certain circumstances, to apply a liability owed by it to a customer for instance an obligation to repay money deposited with it, such as in a deposit account, against a debt the same customer owes that becomes repayable, such as under a Derivative Transaction.

There could be situations where, following the Scheme, additional set-off rights are created for NatWest Markets. For example this could occur where before the Scheme, NatWest Bank was owed a debt from a customer and NatWest Markets owed a debt to the customer. Before the Scheme no set-off would generally be available under many statutory insolvency set-off regimes owing to a lack of mutuality. However, following the Effective Date and the implementation of the Scheme, the requisite mutuality would be created whereby set-off of the two claims could be possible in an insolvency of the customer. This could leave NatWest Markets with a set-off right in insolvency following the Scheme, which it otherwise would not have had. The Scheme Document states that after the Effective Date, for a period of three months, NatWest Markets will not be able to exercise these additional rights, for example to apply money it owes in respect of deposits received against debts transferred to it on Derivative Transaction contracts as a consequence of the Scheme. RBS does not believe any such situations exist but will offer this additional protection as a precaution. The decision to waive these additional rights for three months is in line with precedent in certain other banking business transfer schemes under Part VII of FSMA and the First Scheme. In addition, RBS will also offer the customer a period of three months from the Effective Date to move money, including longer term contracts such as fixed term deposits, without any charge or loss of interest.

As no such positions are thought to exist, and due to the additional protection offered, I have concluded that there is no Adverse Effect as a result of the Scheme.

5.5.5.2 Customer/ counterparty insolvency – loss of set-off rights for the RBS Group

There could be situations where, following the Scheme, the RBS Group has reduced set-off rights in the event of the customer becoming insolvent. For example this could occur in a scenario where NatWest Bank was owed a debt through a loan or mortgage and owed a debt to the same counterparty through a Derivative Transaction contract. In the event of insolvency of the counterparty, the debt owed by NatWest Bank would be offset against the debt owed to NatWest Bank. If through the Scheme the debt owed through the Derivative Transaction transferred to NatWest Markets, NatWest Bank would cease to have the direct benefit of this amount and accordingly, lose the ability to make such offsets.

This would not be an Adverse Effect for counterparties being transferred as the debt owed to and from the counterparty would not change. From RBS's perspective, RBS has performed an analysis of those customers in difficulties who also have a Derivative Transaction position where the mark-to-market valuation is in favour of the customer. This analysis shows that the impact of this loss of set-off would be minimal, and as a result I do not consider that there is an Adverse Effect for other Stakeholders in this respect.

5.5.5.3 Insolvency or resolution of RBS Group companies – loss of customer set-off rights

Close-out Netting

When ISDA Master Agreements are terminated following, for example, a credit event, the value of amounts due to and from parties to the agreement are netted when calculating the amount to be settled. As Netting Sets will be maintained under the Scheme in circumstances where no opt-out is exercised by a counterparty, I have concluded that there is no Adverse Effect in this respect. It is expected that Eligible Derivative Transactions will be transferred as part of the Scheme alongside Ineligible Derivative Transactions unless the counterparty decides that Eligible Derivative Transactions will remain in NatWest Bank. If a counterparty decides that Eligible Derivative Transactions should not be transferred as part of the Scheme, existing Netting Sets could be broken. I do not consider that it is likely that either NatWest Bank or NatWest Markets will become insolvent and therefore on this basis I consider any impact to be limited and by itself would not represent an Adverse Effect. However the Netting Sets may affect the calculation of Credit Valuation Adjustments against Derivative Transactions exposures and therefore I have concluded that there may be an Adverse Effect of the Scheme.

I have therefore considered part (b) of the Statutory Question.

Counterparties could choose for all Eligible Derivative Transactions to be transferred in which case there would be no changes to Netting Sets and so no Adverse Effect.

There is however a potential Adverse Effect for those counterparties that choose to leave Eligible Derivative Transactions with NatWest Bank whilst Ineligible Derivative Transactions are transferred by the Scheme. This decision may be driven by counterparties desiring to maintain hedge accounting or due to the effect of the transfer on the fair valuation of Derivative Transactions. Overall I consider the primary Adverse Effects of the Scheme to be in respect of hedge accounting and fair valuation and the option to leave Eligible Derivative Transactions in NatWest Bank is designed to negate these Adverse Effects, which I note are fairly limited in themselves and may only effect certain counterparties. Although there will be potentially a loss of payment netting if such an election is made, as this is driven by the choice of the counterparty and a requirement to transfer Ineligible Derivative Transactions, I am satisfied that this is a reasonable course of action for RBS to have followed. Therefore, whilst I have concluded that there is an Adverse Effect as a result of the Scheme, I do not consider that this is likely to be greater than is reasonably necessary in order to achieve the relevant purpose of Section 106B(3)(a).

Other contractual set-off

RBS has conducted an analysis which has not identified any such arrangements containing such customer contractual set-off rights. I also note that contractual set-off would only be exercisable in the event of the default of the relevant legal entities, which I do not consider to be probable. As a result, I do not consider that the Scheme would lead to an Adverse Effect.

Non-contractual set-off

Where a customer has no contractual rights of set-off, the general UK insolvency law will still in some circumstances allow or require set-off of reciprocal claims between a customer and an entity. There are equivalent statutory set-off rules in the modified forms of insolvency/resolution proceedings which can also apply to banks under the Banking Act 2009. English statutory insolvency set-off rules rely on the concept of "mutuality". This requires that there have been "mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt" in liquidation or administration. Therefore if the Scheme results in a debt owed by a customer to an entity to be separated from the debt owed from that entity, mutuality would no longer exist.

For there to be a financial detriment to customers in this respect:

- the RBS entity would have to be put into insolvency or resolution;
- the customer would itself still be solvent at the time that the RBS entity defaulted; and
- at the time of the RBS entity default, there would have to be debts owed to that entity from the customer which could have been offset against debts owed from the entity which could have been offset if the Scheme had not occurred.

I do not consider that these events are likely to occur. In particular I note that I do not consider that it is likely that NatWest Markets will be put into insolvency, and in any event since the introduction of the Banking Act 2009, it is likely that other methods (such as the bail-in of liabilities) may be used rather than a traditional insolvency or administration proceeding. In addition I note that many Stakeholders would be considered more likely to default than a regulated bank and as at the date of this Scheme Report, in many instances there is no such set-off position as the current value of outstanding Derivative Transaction positions is more often in favour of RBS. I note that this could change in the future.

As well as the above situation being unlikely, I have considered the fact customers did not originally negotiate such express contractual arrangements.

Having taken all these factors into account, I do not consider there to be an Adverse Effect for customers in this respect.

5.5.5.4 Windfall rights

As set out in Section 5.3.5, the transfer of Derivative Transactions through the Scheme will affect rights such as:

- All monies
- Consolidation rights
- Cross default rights

Provisions have been made in the Scheme Document for such arrangements and as a result, as set out in Section 5.3, I have concluded that there are no Adverse Effects as a result of the Scheme.

5.5.5.5 Payment netting

Payment netting under an ISDA Master Agreement allows the parties on an intra-day basis during the life of a transaction to net amounts payable and receivable on the same day and in the same currency either in respect of the same transaction or two or more transactions. If all Eligible Derivative Transactions are transferred, Netting Sets will be maintained under the Scheme, and where this is the case, I have concluded that there is no Adverse Effect in this respect. If a counterparty decides that Eligible Derivative Transaction contracts should not be transferred as part of the Scheme, existing Netting Sets could be broken and this could result in separate payments being required to be made to separate entities. I consider this to represent an Adverse Effect of the Scheme as although this would be at the choice of the counterparty, it would be the Scheme that would be transferring Derivative Transactions which would result in the breakage of Netting Sets.

I have therefore considered part b) of the Statutory Question.

Counterparties could choose for Eligible Derivative Transactions to be transferred in which case there would be no changes to Netting Sets and so no Adverse Effect.

There is however a potential adverse effect for those counterparties that choose to have Eligible Derivative Transactions remain with NatWest Bank whilst Ineligible Derivative Transactions are transferred by the Scheme. This decision may be driven by counterparties desiring to maintain hedge accounting or due to the effect of the transfer on the fair valuation of Derivative

Transactions. Overall I consider the primary Adverse Effects of the Scheme to be in respect of hedge accounting and fair valuation and the option to leave Eligible Derivative Transactions in NatWest Bank is designed to negate these Adverse Effects, which I note are fairly limited in themselves and may only effect certain counterparties. Although there will be potentially a loss of payment netting if such an election is made, as this is driven by the choice of the counterparty and a requirement to transfer Ineligible Derivative Transactions, I am satisfied that this is a reasonable course of action for RBS to have followed. Therefore, whilst I have concluded that there is an Adverse Effect as a result of the Scheme, I do not consider that this is likely to be greater than is reasonably necessary in order to achieve the relevant purpose of Section 106B(3)(a).

5.5.6 Operational and service effects

In respect of operational and service effects:

- The existing contracts and arrangements will transfer as part of the Scheme and there will be no changes to the payments in respect of these contracts with the exception that payments will involve a new account with NatWest Markets after the Effective Date. This will require counterparties to change Standard Settlement Instructions in respect of payments made in respect of Derivative Transactions (including in respect of associated collateral arrangements). I understand that this is a task which is administrative in nature and so I have concluded that this does not represent an Adverse Effect of the Scheme.

5.5.7 Access to products

New Derivative Transactions entered into after the Effective Date will be made with NatWest Markets rather than NatWest Bank as NatWest Bank will no longer offer such products. Whilst there will be a product curtailment in NatWest Bank this is a strategic decision and is not driven by the Scheme itself and so I do not consider that this is an Adverse Effect of the Scheme. I also note that RBS has stated that all products will continue to be offered by NatWest Markets and so there will be no product curtailment for Derivative Transaction counterparties.

5.5.8 Other contractual provisions

As set out in Section 5.3.8, if approved, certain administrative changes will be made by the Scheme in order to allow the transferred business to operate from NatWest Markets following the Effective Date. As set out in Section 5.3.8, I understand that these are administrative in nature and do not represent Adverse Effects.

RBS has undertaken a legal due diligence exercise with respect to the transferring business in order to:

- identify any potential breaches of agreements or contractual rights triggered by the Scheme which, subject to any jurisdictional issues, the Scheme, subject to Court sanction, will override;
- identify the terms of any agreements which the Scheme, subject to Court sanction, will amend to make the relevant agreement work when transferred to NatWest Markets; and
- identify any issues which might form the basis of an objection to the Scheme or which may constitute an Adverse Effect on a customer or Stakeholder.

I have considered the results of the legal due diligence undertaken and overall I have concluded that there is no Adverse Effect. Key issues that I have considered are set out below:

5.5.8.1 Non-UK law

As set out in Section 5.3.8.1, I do not consider that there is an Adverse Effect of the Scheme.

5.5.8.2 Restrictions on transfer

The legal due diligence has identified a number of contractual provisions which will be overridden through the Scheme’s transfer process. These include:

- **Restriction on transfers:** there are certain contracts where transfers are prohibited; and
- **Consent to transfer from counterparty:** there are certain contracts where consent to transfer is required from the counterparty.

I also note that certain contracts contain either a requirement to give notice of transfer to the counterparty, or a requirement for consent from either the counterparty or a third party.

These contractual provisions would be overridden if the Scheme were approved and I have taken these into account when reaching my conclusions in respect of Adverse Effects. Where I do not consider there is an Adverse Effect for transferring counterparties, I do not consider there to be an Adverse Effect for counterparties that have certain rights overridden by the Scheme.

5.5.8.3 Effects of changes in credit rating

The legal due diligence has also identified instances in certain transferring agreements where a transfer to a lower rated counterparty gives rise to termination rights for a counterparty or ongoing obligations on NatWest Markets to take particular action (or a range of possible actions), for example the posting of collateral. As set out in Section 5.3.8.3, I do not consider that the Scheme has an Adverse Effect in this respect as RBS has elected to preserve the rights (e.g. termination and other enforceable actions) that were contractually predetermined. Therefore the counterparty continues to have such rights as a result of the Scheme.

5.5.8.4 ISDA Master Agreement provisions

ISDA Master Agreements generally contain a number of termination provisions, including those which give counterparties the right to terminate contracts when certain requirements are met (including the occurrence of certain creditworthiness or other credit related events). If these provisions would otherwise be triggered by the circumstances arising from the Scheme, the rights would not be enforceable as a matter of law.

RBS has concluded that there are no such ISDA termination events triggered as a result of transfers that will be effected through the Scheme. As set out in Section 5.3, I have reviewed RBS’s reasons for reaching this conclusion, and based on this review I have concluded there is no Adverse Effect in this respect.

5.5.9 Option not to transfer Derivative Transactions

As discussed in Section 5.4.9 RBS will offer counterparties an option to leave Eligible Derivative Transaction contracts with NatWest Bank. Whilst I have considered the Adverse Effects of the Scheme, I have not considered whether the option to leave Eligible Derivative Transactions in NatWest Bank would result in a better outcome for that counterparty than a transfer of all Derivative Transactions – I do not know the particular facts and circumstances of each counterparty and hence I am not able to determine which course of action a counterparty should follow. My Report does not make this determination.

A counterparty should consider its particular facts and circumstances and this is not something I have sought to do here. As the ability exists for counterparties not to be part of the Scheme and hence their position would be unchanged, I have concluded that this a reasonable course of action for RBS to take.

5.5.10 Conclusion

Other than the matter set out in Sections 5.5.2, 5.5.3 and 5.5.5, I am satisfied that there are no Adverse Effects as a result of the Scheme in respect of Counterparties with both Ineligible and Eligible Derivative Transactions. In respect of the matter in Sections 5.5.2, 5.5.3 and 5.5.5, I am satisfied that the Adverse Effect is not likely to be greater than is reasonably necessary in order to achieve the specific purpose of enabling a UK authorised person to carry on core activities as a ring-fenced body in compliance with the ring-fencing provisions (Section 106B(3)(a) of FSMA).

5.6 Counterparties with no live trades at the time of transfer

Any Secured Empty Arrangements between NatWest Bank and a counterparty where there are no live trades in existence but where there is a shared security arrangement in place will transfer as part of the Scheme.

As there are no live trades between NatWest Bank and the counterparty, there are no credit risk, hedge accounting or set-off issues.

The only consideration for these counterparties is shared security.

5.6.1 Shared security

Certain customers have granted security to NatWest Bank which covers more than one exposure for example as both security for loans and Derivative Transactions. In the event of default or insolvency of the customer, this security would be enforceable by NatWest Bank with respect to the total amount of the secured exposure. Customers who have provided security on an 'all monies' basis which secures some or all of their liabilities to NatWest Bank, including any Derivative Transactions entered into by them from time to time (which would include any new Derivative Transactions entered into after the Scheme takes effect), but who have no live transactions which will be outstanding after 31 August 2018 are also affected by this change.

Following the Scheme, the total secured exposure of these customers will be split between NatWest Bank and NatWest Markets with, for example, their Secured Empty Arrangements transferring to NatWest Markets but their existing loan remaining in NatWest Bank.

There will be an amendment, under the Scheme, to ensure that such security secures the total exposure for the RBS Group, even if owed to multiple companies after the Scheme, such security to be held by NatWest Bank as trustee for those relevant RBS Group companies. There will also be an inter-creditor agreement which will set out the treatment to be followed between NatWest Bank, NatWest Markets and other relevant RBS Group companies. As a result I have concluded that there is no Adverse Effect on the relevant Stakeholders:

- From a customer perspective, neither the total amount of the security nor the amount owed will change, although it will be owed to a greater number of companies. Whilst there may now be two parties with differing objectives who may exercise these rights, the total amount of the security will not change;
- No significant additional obligations will be imposed on the customer under either the security agreement or the inter-creditor agreement; and
- From the perspective of NatWest Bank and NatWest Markets, their aggregate commercial position will be unchanged before and after the Scheme as they will, between them, have the benefit of the same security for the same exposures (including exposures incurred after the Effective Time which would have been secured by such shared security had the Scheme not taken effect). As between each other, the benefit of such security will be shared proportionately by reference to each entity's secured exposures, and so their proportionate recovery on the security will be unchanged before and after the Scheme, although the inter-creditor agreement will contain some new inter-creditor provisions on arm's length terms as required under ring-fencing legislation.

I have relied upon legal advice provided to RBS in relation to the proposed shared security mechanism.

5.6.2 Conclusion

I am satisfied that there are no Adverse Effects as a result of the Scheme in respect of Counterparties with no live trades at the time of transfer.

5.7 Litigants and other claimants against NatWest Bank

Under the Scheme any litigation or claim that is associated with the transferring NatWest Bank derivative business will transfer with the business to NatWest Markets. This approach is set out in the Scheme Document and will also be explained to Stakeholders in the Scheme communications (as covered in Section 12 - Communications).

There will be no operational change for any transferring ongoing claims. The claims handling process and contacts will remain the same as before the Scheme.

Any claim or litigation associated with a Derivative Transaction where the counterparty chooses to exit at market value will transfer to NatWest Markets along with the transferring business.

However, any claim or litigation associated with an Eligible Derivative Transaction that is opted out of the Scheme will remain with NatWest Bank.

In any situation where a claim or litigation specifically relates to more than one Derivative Transaction and where some of those Derivative Transactions will transfer to NatWest Markets but some will remain with NatWest Bank, the claim or litigation will by default transfer to NatWest Markets under the Scheme, unless RBS agrees to a request from the counterparty for it to remain with NatWest Bank.

5.7.1 Conclusion

Based on my assessment of the financial position of NatWest Markets as set out in more detail in Section 7 (Financial Considerations), I do not consider that the Scheme results in an Adverse Effect on litigants that are being transferred to NatWest Markets.

6 Effect on other Stakeholders

6.1 Introduction

In this section, I will set out my conclusions in respect of the effect of the Scheme on a range of other Stakeholders, such as customers remaining in NatWest Bank ("Remaining NWB Customers"), and existing customers and counterparties of NatWest Markets ("Existing NWM Customers").

6.2 Remaining NWB Customers

As this Scheme is small in size and specific to certain Derivative Transaction products and customers, the potential impact to the Remaining NWB Customers is expected to be limited from both an operational and a financial perspective. The transferring business currently represents less than 1% of the Balance Sheet of NatWest Bank, and as a result the transfer will not significantly change the profitability, capital or liquidity position of the entity.

6.2.1 Service and operational considerations

I am satisfied that there is no Adverse Effect for Remaining NWB Customers from a service and operational perspective as a result of the Scheme.

My opinion is driven by the following key factors:

- There will be no effect on funds held in accounts at the Effective Date as they are not subject to the Scheme. There are no planned changes to account details such as sort codes and account numbers and no need to change payment instructions such as direct debits and standing orders;
- There is no change in legal entity, name or branding. As such there will be no requirement for any change in contractual terms including related legal agreements, stationery or payment collateral; and
- Operationally NatWest Bank will not be significantly affected by the Scheme. There will be no significant change in the volume of customer transactions or the level of shared services consumed by NatWest Bank, and no significant change in the IT system population or architecture.

6.2.2 Financial considerations

I am satisfied that there is no Adverse Effect for remaining NatWest Bank customers from a financial perspective as a result of the Scheme.

My opinion is driven by the fact that NatWest Bank is a regulated entity and licensed bank and hence subject to regulatory capital and liquidity requirements. On both these measures, RBS's financial projections indicate that a surplus above regulatory requirements exists as at the Effective Date and in the future period thereafter considered by RBS management. These measures are not materially affected by the Scheme.

6.2.3 Conclusion

For the reasons set out above, I am satisfied that there is no Adverse Effect as a result of the Scheme in respect of remaining NatWest Bank customers.

6.3 Existing NWM Customers

As discussed in section 6.2, as this Scheme is small in size and specific to certain Derivative Transaction products and customers, the potential impact to Existing NWM Customers is expected to be limited from both an operational and a financial perspective. The transferring business currently equates to less than 1% of the Balance Sheet of NatWest Markets, and as a result the transfer will not significantly change the profitability, capital or liquidity position of the entity.

6.3.1 Service and operational considerations

I am satisfied that there is no Adverse Effect for Existing NWM Customers from a service and operational perspective as a result of the Scheme.

My opinion is driven by the following key factors:

- As no transfer of Existing NWM Customers is taking place there will be no effect on products held at the Effective Date;
- There is no change in legal entity, name or branding as a result of the Scheme. As such there will be no requirement for any change in contractual terms including related legal agreements; and
- Operationally NatWest Markets will not be significantly affected by the Scheme. There will be no significant change in the volume of customer transactions or the level of shared services consumed by NatWest Markets, and no significant change in the IT system estate or architecture.

6.3.2 Financial considerations

I am satisfied that there is no Adverse Effect for Existing NWM Customers from a financial perspective as a result of the Scheme.

My opinion is driven by the fact that NatWest Markets is a regulated entity and licensed bank and hence subject to regulatory capital and liquidity requirements. On both these measures, RBS's financial projections indicate that a surplus above regulatory requirements exists as at the Effective Date and in the future period thereafter considered by RBS management. These measures are not materially affected by the Scheme.

6.3.3 Conclusion

For the reasons set out above, I am satisfied that there is no Adverse Effect as a result of the Scheme in respect of Existing NWM Customers.

6.4 Employees of NatWest Bank and NatWest Markets

As noted in 3.3.2 employees are not affected by the Scheme.

6.5 Pensions

I have considered whether RBS's pension schemes are likely to be adversely affected by the Scheme. For this purpose, I have considered the Stakeholders to be:

- the beneficiaries of the RBS pension schemes – that is anyone who is entitled to, or who might receive, a benefit from the scheme, now or in the future. The benefits that the beneficiaries receive will ultimately rely on funding from the sponsoring companies; and
- the pension trustees – in line with their fiduciary duties, the trustees are responsible for governing the scheme in line with the trust deed and rules and acting in the best interest of scheme beneficiaries. The trustees' responsibilities include the investment of scheme assets and ensuring that contributions are paid on time.

RBS operates a number of defined benefit ("DB") and defined contribution ("DC") pension arrangements.

Under a DB pension scheme, the member receives a specific retirement benefit amount which is usually based on salary and years of service. Employee members generally pay a specified contribution whilst the sponsoring companies meets the balance of the cost, and therefore bears the funding risks of ensuring benefits are able to be paid to the beneficiaries.

Under a DC pension scheme, contributions from the employee member and sponsoring company are paid in to an investment account which is used to provide benefits to the member on retirement. Since there is no funding risk to the sponsoring company in relation to DC pension arrangements, I do not consider that the Scheme has an Adverse Effect on the DC Stakeholders.

In respect of the DB stakeholders:

- The transfer of business and assets under the Scheme is immaterial in size to NatWest Bank.
- In any case, in relation to RBS's main DB pension scheme (the Royal Bank of Scotland Group Pension Fund) the transfer is between two participating employers and therefore the scheme will continue to have direct access to the combined assets and earnings.

As such I do not consider that the Scheme will materially affect the DB pension schemes of RBS.

Accordingly, I am therefore satisfied that RBS's pension schemes will not suffer an Adverse Effect as a result of the Scheme.

6.6 Suppliers

The Scheme does not have any direct effect on supplier contracts. Based on my assessment of the effect of the Scheme on the financial position of NatWest Bank and NatWest Markets as set out in more detail in Section 7 (Financial Considerations), I do not consider that the Scheme results in an Adverse Effect on suppliers.

6.7 Creditors of NatWest Bank

As the Scheme is not material to the financial position of NatWest Bank, I do not consider that the Scheme has an Adverse Effect on creditors of NatWest Bank.

6.8 Creditors of NatWest Markets

As the Scheme is not material to the financial position of NatWest Bank, I do not consider that the Scheme has an Adverse Effect on creditors of NatWest Bank.

6.9 RBSG plc shareholders

Numerous factors influence the share price of an entity and share prices take into account expectations in respect of future performance and events. The ring-fencing requirements which come into effect at the end of 2018 have been a matter of public knowledge for some time, as are some of the expected costs of ring-fencing which as set out in the Independent Commission on

Banking ("ICB") Final Report Recommendations of September 2011 include increased funding costs for banking groups and the cost of implementation itself. Therefore it is my expectation that the share price will have taken some account of these events.

The Scheme itself is only one part of ensuring compliance with the ring-fencing legislation and due to the forward looking nature of a share price, I do not consider it possible to separate and quantify any effect that the Scheme would have although I note that by itself, it largely results in a transfer of assets and liabilities between RBS Group companies. Therefore I do not consider that the Scheme has an Adverse Effect on RBSG plc shareholders.

6.10 RBSG plc bondholders

As the Scheme itself is only transferring businesses between underlying RBS Group companies, I do not consider that the Scheme itself has an Adverse Effect on RBSG plc bondholders.

7 Financial considerations

7.1 Introduction

In Sections 5 and 6 of this Scheme Report I have set out my conclusions in respect of the effect of the Scheme on various Stakeholders. This includes my conclusions in respect of the financial effect on these Stakeholders. These conclusions are based on a number of factors including consideration of the effect of the Scheme on the financial position of the Scheme Companies. In this section I have set out some key financial information that I have reviewed in reaching my conclusions. As some of this information is not publicly available, I have not set out in this Scheme Report all of the financial information I have considered.

7.1.1 Overview of regulatory capital requirements

A key part of bank regulation is to make sure that firms operating in the industry are prudently managed. Regulatory rules set out the level of capital that banks need to hold with the objective of ensuring continuation of a safe and efficient service.

Banks' minimum capital requirements are determined by Risk Weighted Assets ("RWA") which assigns "weights" to the bank's assets and other exposures to reflect the probability of incurring losses due to different types of risks such as credit risk, counterparty credit risk, market risk and operational risk.

Not all forms of capital are equal. There are various measures of a bank's capital resources depending on their capacity to absorb losses.

The highest quality of capital is known as Common Equity Tier 1 ("CET1"), although there are several other measures of regulatory capital. While I have seen and considered the details of the other measures for the purposes of this Scheme Report I have focussed on CET1. This is comprised of ordinary shares and reserves less certain regulatory adjustments and deductions.

Banks need to meet certain minimum capital requirements at all times, referred to as Pillar 1 requirements. In terms of CET1 capital, the CET1 capital ratio (CET1 to RWA) needs to be at least 4.5%.

Banks are subject to an additional minimum requirement referred to as Pillar 2A which is aimed at addressing risks not fully captured in Pillar 1. Pillar 2A requirements are firm-specific and are calibrated by the regulator.

7.1.1.1 Capital buffers

The amount of capital that a bank needs to hold at all times to meet minimum capital requirements is increased by holding buffers of such capital so that the bank can absorb losses and meet the minimum requirements under most circumstances. These include:

- The Capital Conservation Buffer ("CCB") under which banks need to hold additional CET1 capital equivalent to 1.25% of RWA, increasing to 1.875% from January 2018, i.e. before the Effective Date. This CCB will increase to 2.5% of RWA by January 2019, i.e. the date by which ring-fencing must be implemented.
- The Countercyclical Capital Buffer ("CCyB") which is intended to protect banks from the build-up of system-wide risks through excess credit growth. It is set by the Financial Policy Committee (FPC) of the Bank of England ("BoE") for the UK. The overall amount of CET1 capital that banks need to hold as a percentage of RWA varies over time, both up and down, and is currently set at nil for the UK. The UK CCyB will increase to 0.5% from 27 June 2018.

- The PRA buffer refers to the additional amount of CET1 capital set using supervisory judgement to increase a bank's resilience under a stress scenario so that banks can meet their minimum capital requirements during a stress period. The PRA buffer is firm-specific and a larger buffer applies to banks with poor risk management and governance or above-average sensitivity to the business cycle.
- An additional capital buffer applies to the RBS Group due to its systemic importance and global presence. The Global Systemic Importance Buffer ("G-SIB") range is being phased in between 2016 and 2019 and requires additional CET1 of between 1% and 2.5%. The level of application of this requirement is at the RBS Group level.
- A capital buffer called the Domestic Systemic Risk Buffer ("D-SRB") will apply from 2019 to the RFB Subgroup. It will not apply to the NRFB. This buffer will complement the G-SIB by focusing on the effect of the potential distress or failure of the RFB on the UK economy as opposed to the global economy. Banks will need to hold additional CET1 in a range between 0% and 3% of RWAs according to their relative importance to the UK economy.

In practice, banks hold capital resources at or above their internally set risk appetite levels. These levels are set above the level required to meet minimum capital requirements and holdings of capital buffers in order to avoid regulatory breaches.

7.1.1.2 Leverage ratio requirement

The leverage ratio ("Leverage Ratio") is used to measure how much capital a bank has relative to its overall assets. It is a non-risk based metric since it is not measured relative to RWA. A lower Leverage Ratio would point to a higher level of debt. This is therefore an important measure to supervisors because banks use the money they have borrowed from depositors and bondholders to lend to other customers.

Banks are required to meet a minimum leverage requirement calculated as a ratio of capital to a Total Exposure Measure. It captures the value of the bank's total assets with some additional adjustments to account, for example, for certain exposures that are not accounted for in the balance sheet.

The minimum Leverage Ratio applies in the UK to PRA regulated Banks with retail deposits equal to or greater than £50 billion on a consolidated or individual basis. Such banks are required to hold sufficient capital to meet a 3% minimum Leverage Ratio of which at least 75% needs to be met with CET1.

A supplementary leverage buffer will apply once the D-SRB has been implemented in 2019.

In addition to minimum regulatory capital requirements and holding of capital buffers, banks also face requirements in relation to the amount of liabilities that are able to withstand losses once a bank has entered into resolution or liquidation. These are known as Minimum Requirement for Own Funds and Eligible Liabilities ("MREL") and are considered in Section 10.7.

7.1.2 Overview of regulatory liquidity requirements

In addition to capital, banks have to maintain appropriate levels of liquidity. Liquidity is a measure of how easily a bank can turn its assets to cash in order to meet its obligations, a simple example being to meet the needs of customers who wish to withdraw cash on a day-to-day basis.

Banks are subject to two sets of requirements in relation to liquidity risk, referred to as Pillar 1 and Pillar 2.

7.1.2.1 Pillar 1 liquidity requirements

Pillar 1 requires firms to meet a Liquidity Coverage Ratio (LCR) requirement. The LCR is a measure of the ability of a bank to cover the net cash outflows that would be experienced under a stress scenario over the next thirty calendar days with a pool of defined High Quality Liquid Assets ("HQLA"). HQLA are securities that are deemed to be easily and immediately converted into cash, and include government bonds and other securities.

Currently all banks need to have an LCR equal to or greater than 100%; that is, a bank would have a pool of HQLA sufficient to cover 100% of its stressed net cash outflows over the next thirty days.

In the future, a further requirement known as Net Stable Funding Ratio ("NSFR") will apply to banks. The NSFR will require banks to hold sufficient funding considered to be 'stable' in times of stress, known as Available Stable Funding ('ASF'), to finance any funding requirements arising from its assets. This is known as Required Stable Funding ("RSF"). The NSFR is calculated as the ratio of ASF to RSF. A minimum NSFR will apply at a level of 100%. The actual date of implementation is still unknown but the NSFR will not be in place at Effective Date.

7.1.2.2 Pillar 2 liquidity requirements

Banks are subject to additional minimum liquidity requirements referred to as Pillar 2 to reflect risks not fully captured in Pillar 1 such as the risk that a bank is not able to meet payment and settlement obligations on a timely basis throughout the course of a day, known as intraday liquidity risk. Pillar 2 requirements are met with additional HQLA, are firm-specific and are set by the regulator.

7.1.2.3 Level of application of liquidity requirements

For a number of firms which form part of the same bank group, the supervisor may, at the firms' request, apply liquidity requirements as a single sub-group, known as a Domestic Liquidity Sub-group ("DoLSub"). For this to apply, the supervisor would need to confirm that specific conditions relating to the free transferability of HQLA among such legal entities are met. At the Effective Date, the entities will all be members of an existing DoLSub consisting of NatWest Bank, NatWest Markets, RBS plc, Coutts and Ulster Bank. Future changes to the DoLSub are discussed further below in Section 7.4.

7.2 Approach

In making my assessment, I have considered the following:

- **Effect of Transfers.** The Effective Date is expected to be 13 August 2018. At close of business on 12 August 2018, certain assets and liabilities of NatWest Bank will be transferred to NatWest Markets. I have therefore analysed the forecast position of the affected entities as at 12 August 2018, being the expected last day preceding the Scheme, and 13 August 2018, being the expected first day of the implementation of the Scheme.
- **Financial Viability.** As well as assessing the effect of the Scheme from a capital and liquidity perspective both before and immediately after the Effective Date, I have considered the effect of the transfers on the business-model viability and sustainability of the entities. I have made this assessment by considering whether the planned financial performance of the entities indicates concerns that they would not be able to meet regulatory requirements following the Scheme.

As noted above, banks hold capital resources at or above their internally set risk appetite levels. These levels are set above the level required to meet minimum capital requirements and holdings of capital buffers in order to avoid regulatory breaches. In making my assessment, where there

are capital resources in excess of the risk appetite of any company, I placed limited weight on it as it could potentially be removed at any future point, for example by the payment of dividends. However I do expect that capital resources should meet the levels required by the risk appetite of a company (where set) and I expect that these levels should be above the minimum capital ratio requirements including buffers so that a capital surplus is maintained.

For example, if Stakeholders are transferred from a company with higher capital ratios to another company with lower capital ratios but these are still well in excess of minimum regulatory requirements, I would not immediately consider this to be an Adverse Effect for Stakeholders as the capital resources required by the transferee's risk appetite may provide an acceptable minimum ongoing level of financial strength and cannot be weakened arbitrarily in future. If however Stakeholders are transferred to a company where the capital ratio is marginally above the minimum capital requirements, I may consider this to be an Adverse Effect. My assessment of Adverse Effects is made by groups of Stakeholders and effects on capital resources may have different consequences for different Stakeholder groups. For example, a change in capital resources may affect the fair value of a financial instrument without having a significant effect on whether the obligations on a financial instrument (e.g. interest and principal repayments) can be met.

My analysis of the financial position of NatWest Bank and NatWest Markets is based on profitability projections and capital and liquidity calculations. The estimates have been produced by the RBS Group and I have relied on them in carrying out my analysis. They have been prepared on the assumption that the Scheme and all other ring-fencing plans have been implemented, I consider it reasonable to use the profitability projections and the capital and liquidity calculations since:

- The models, processes, and data used to estimate the pre-Scheme position of NatWest Bank and NatWest Markets by the RBS Group are well established and where processes have been amended in order to update estimates for the purpose of the Scheme, these have been subject to additional governance procedures within the RBS Group;
- I asked the RBS Group to explain, check and/or clarify any results that seemed to me unreasonable or inconsistent with other data and information. I can confirm that all my queries have been answered to my satisfaction;
- I have reviewed how RBS has estimated the effects of the Scheme on the underlying financial data and the effects on individual legal entity projections. This has included for example consideration of the transfers of assets and liabilities including claims and litigation provisions as a result of the Scheme and associated financial effects such as revenue allocations, cost allocations, funding implications and the proposed allocation of specific one-off items;
- I am satisfied that the forecasts have been prepared using assumptions which are consistent to those adopted by RBS in their annual planning cycle and in the capital plans presented to regulators; and
- I have reviewed the results of the stress testing performed by RBS in respect of the financial projections. RBS has confirmed that this has been subject to RBS governance processes.

As part of my analysis, I have considered projections provided by the RBS Group of the expected capital and liquidity position of the Scheme Companies at the Effective Date. I note that the financial position at the Effective Date cannot be predicted with certainty. The capital position of the Scheme Companies at the Effective Date will therefore differ from the projections I have considered. As the information from these projections is not public, it has not been reproduced here.

7.3 Effect of transfer – capital adequacy

This section sets out my considerations in relation to the immediate effect of the Scheme on the capital resources of the Scheme Companies as at the Effective Date. I have been provided and considered the effect of the Scheme on all relevant capital ratios.

7.3.1 NatWest Markets

Due to the small size of the transferring business, the Scheme has a very limited effect on the capital ratios of NatWest Markets. Therefore I do not consider that the Scheme will have an Adverse Effect to the entity in terms of capital adequacy.

7.3.2 NatWest Bank

Due to the small size of the transferring business, the Scheme has a very limited effect on the capital ratios of NatWest Bank. Therefore I do not consider that the Scheme will have an Adverse Effect to the entity in terms of capital adequacy.

7.4 Effect of transfer – liquidity

As noted in 7.3.1 and 7.3.2 above, due to the small size of the transferring business, the Scheme has a very limited effect on the liquidity position of both NatWest Bank and NatWest Markets.

In addition, at the Effective Date, NatWest Bank and NatWest Markets will both be members of the existing liquidity sub-group ("DoLSub"). As a result, the overall liquidity position of the DoLSub, including its LCR and Pillar 2 requirements will remain unchanged. There is therefore no Adverse Effect as at the Effective Date.

Changes to the DoLSub will occur at a later stage. It is expected that NatWest Markets will be leaving the DoLSub in November 2018. After this event, separate minimum Pillar 1 and Pillar 2 liquidity requirements will apply to NatWest Markets and the DoLSub. I have considered future projections and minimum liquidity requirements in reaching my conclusion that there is no Adverse Effect from the Scheme.

7.5 The Capital Support Deed

NatWest Bank and NatWest Markets are parties to a capital support deed ("CSD"), whose overall purpose is to ensure that these banks can easily move capital amongst themselves if that is required for any reason. Under its terms, each entity may be required to make distributions on, or repurchase or redeem, its ordinary shares. The amount of this obligation is limited to amounts in excess of those needed to meet capital requirements.

Additionally, each entity taking part in the CSD may also be required to make onward distribution to its ordinary shareholders of dividends or other capital distributions received from subsidiaries that are party to the CSD.

The arrangement also provides that, in certain circumstances, any funding received by an entity from other entities which are also parties to the arrangement would become immediately repayable, with the repayment obligation limited to the available resources of the receiving entity.

The continuation of the CSD immediately after the Scheme is another reason that I do not consider that the Scheme creates an Adverse Effect in respect of how the entities meet their regulatory requirements.

Changes to the CSD in November 2018 are considered below.

7.6 Effect of Scheme on business viability and sustainability

As stated above, I have considered the effect of the Scheme on the business viability and sustainability of the entities involved.

The future business performance of any entity and ability to meet regulatory requirements will be affected by a number of other changes both internal and external. For example:

- By the time of the Effective Date there will have been a reduction of capital in NatWest Markets and transfer of underlying subsidiaries;
- The ring-fencing regulations that come into effect at the end of 2018 will significantly restrict the RFB Subgroup from funding entities outside the ring-fence. Therefore even if immediately following the Scheme NatWest Markets can continue to be funded by other RBS Group companies, the implementation of the ring-fencing legislation in the future will cause funding arrangements to change. The current DoLSub structure will change in November 2018 and NatWest Markets will no longer have the same access to funding from the RFB Subgroup. In order to deal with this, RBS plans to fund through MREL downstreaming (see Section 7.7) from RBSG plc level and issuance of debt instruments directly from NatWest Markets. In addition, alternative and contingent funding options have been considered by NatWest Markets which have been outlined in the funding plans that I have reviewed;
- In November 2018, the existing CSD will cease to exist. NatWest Bank will become party to a new CSD. NatWest Markets will, however, not be a party to the new CSD; and
- Capital requirements change over time such as the known changes to the capital conservation buffer that will be required in 2019.

Therefore it is not possible to quantify the changes to business performance that are purely the result of the Scheme as there are many other factors that will affect future financial performance.

My assessment of the effect of the Scheme is therefore qualitative. I have concluded that the Scheme does not affect the assessment of the viability and sustainability of the entities as RBS's financial projections indicate that the regulatory capital and liquidity requirements will be met by the entities in the future period considered by RBS and there will be surpluses above these minimum requirements. As noted in 7.3 and 7.4, due to the small size of the transferring business, the Scheme has a very limited effect on the capital and liquidity positions of both NatWest Bank and NatWest Markets. In addition, financial projections show that the entities remain above the relevant hurdle rates in a range of internally prepared stress testing scenarios. I note that these are the RBS's internal projections and internal stress testing processes. I have not set out details of the financial projections in this Scheme Report as these projections are not published information.

I note that financial projections have inherent limitations and as such can be affected by unforeseen events, consequently resulting in significantly different outcomes.

7.7 MREL/ TLAC

7.7.1 Overview of regulatory requirements

In addition to the regulatory capital requirements, banks also have requirements in respect of their Gone Concern Loss-absorbing Resources. The EU Banking Recovery and Resolution Directive ("BRRD") took effect on 1 January 2016 with the policy intention of avoiding the need for public sector funds being used to support failing banks. It was implemented into UK law through a combination of secondary legislation, rules made by the PRA and policy made by the BoE. The BoE is the UK's Resolution Authority with a range of powers to intervene to manage the failure of a bank.

These resolution powers include the power to impose a 'bail-in' of certain liabilities of a bank. In a bail-in, a central bank is able to write down and/or convert to equity the claims of shareholders and unsecured creditors, subject to various exclusions and with a mechanism to assess compensation after the bail-in ("Bail-in"). The bail-in is intended to re-capitalise the bank, avoid insolvency and buy time to restructure the bank and address its underlying problems. As a Global

Systemically Important Institution ("G-SII") the RBS Group would be subject to a bail-in strategy by the BoE if it were to go into resolution.

In order to ensure that the bail-in can be used, banks are required to adopt a funding structure with a certain proportion of liabilities that can be written off or converted into equity in the event of failure. Those liabilities, in combination with the bank's equity, are known as MREL and applies to all EU banks.

As of 1 January 2019 RBS will be subject to a global standard called Total Loss Absorbing Capacity ("TLAC"). TLAC is broadly similar to MREL but applies only to G-SIIs such as RBS and expresses the minimum required amount of bail-in liabilities in a different way.

7.7.2 RBS approach

The BoE has a published policy for how it will set TLAC/MREL requirements on a consolidated group level, i.e. the quantum that will be required for the RBS Group as a whole, with a transitional period from 2019 to 2022. The first transitional date applicable to the RBS Group is 1 January 2019, by when it must meet the TLAC standard of having eligible bail-in liabilities equivalent to the higher of 16% of RWAs or 6% of leverage exposures. The BoE has not yet specified what requirements will apply to the individual entities.

The RBS Group has in place a programme to issue eligible liabilities from RBSG plc in order to build up the required amount on a consolidated group basis.

As noted above, the BoE has not yet issued a policy on how MREL/TLAC should be downstreamed from RBSG plc to the Scheme Companies. However, the RBS Group has made a working assumption that the same approach to calculating the group-level requirements will apply at the company level.

I note the following in respect of MREL levels which I have factored into my conclusions above in respect of the effect of the Scheme:

- There are no specific regulatory requirements as at the Effective Date. The levels in each of the entities as at the Effective Date are in excess of the minimum requirements of 16% that will apply at the group level as at 1 January 2019.
- I have considered RBS's future MREL projections in reaching my conclusion that I have concluded that there is no Adverse Effect from the Scheme.

7.8 Conclusion

In this section I have set out considerations in respect of the effect of the Scheme on the financial position of NatWest Bank and NatWest Markets. My assessment of Adverse Effects is made by groups of Stakeholders and this includes consideration of the financial position of the Scheme Companies. My conclusions in respect of these groups of Stakeholders are set out in Sections 5 and 6 of this Scheme Report.

8 Governance and risk management considerations

8.1 Governance

Governance standards are set at group level and applied to subsidiaries in line with their size, nature, complexity and importance to the RBS Group. Each of the principal entities involved in the Scheme, namely NatWest Bank and NatWest Markets, has, at present, its own board, committee and senior management structures. Similarly, there is a risk management framework applicable to all of the RBS Group companies and a policy framework that is required to be adhered to by all group companies. In undertaking this review I have sought to establish whether the proposed governance arrangements under the Scheme may result in detriment to this current state.

I note that the governance changes proposed by RBS are subject to regulatory consideration and approval.

8.1.1 Governance of NatWest Markets

NatWest Markets currently has an established board and governance structure that will not change as a result of the Scheme. The established structure will remain after the Scheme, although certain changes are planned during 2018 with regards to the executive personnel given the wider ring-fencing activities and requirements, including recently announced changes to the board membership of NatWest Markets.

As the Scheme is transferring no new types of products or services into NatWest Markets and the assets and liabilities are relatively limited in size compared to the existing business activities, I do not consider that any changes are required in respect of the skills, knowledge and expertise of the Board members. I have therefore concluded that there is no Adverse Effect on governance as a result of the Scheme.

8.1.2 Governance of NatWest Bank

NatWest Bank currently has an established board and governance structure that will not change as a result of the Scheme. However, as with NatWest Markets, certain NatWest Bank board membership changes have been announced in order to address compliance with the PRA rules on ring-fencing in line with the RFB structure being implemented.

I do not consider that there will be any Adverse Effect as a result of the Scheme. In addition I consider the wider amendments to the governance structure to be an enhancement of the entity governance arrangements for NatWest Bank.

8.1.3 Governance of the RBS Group

I have commented above on the effect of the Scheme on the governance arrangements in respect of NatWest Bank and NatWest Markets. I do not consider that the Scheme has an Adverse Effect in respect of the appropriateness of the governance structures in place with regards to those entities.

The governance structure of the RBS Group is being changed with reference to the wider ring-fencing requirements which have to be adhered to by 1 January 2019, including some recently

announced changes to the membership of the RBS Group board. Whilst I have not commented on the compliance with future regulatory requirements, I do not consider that the Scheme has an Adverse Effect on the RBS Group's ability to comply with these future ring-fencing requirements.

8.2 Risk Management - overview

The Scheme will result in the transfer of exposures between legal entities. As such it will be important to ensure that these exposures can be managed on an ongoing basis from the date of transfer. I have considered plans at the legal entity level including the setting of risk appetite, how the changed risk exposures will be managed immediately after the implementation of the Scheme as well as the plans for required changes to ongoing risk management procedures, including the ability to produce the reporting required to manage risks at a legal entity level following the Scheme.

RBS currently has an established risk framework in place to identify, manage and mitigate risks to both its customers and businesses. The RBS Group utilises the three lines of defence model, and this provides a set of principles which all businesses and functions must adopt, implement and comply with. The first line of defence is comprised of the frontline business staff, the second line comprised of oversight functions such as compliance and risk management and the third line comprised of internal audit and the directors. These principles and the associated framework will not change after the implementation of ring-fencing. There is no new risk being introduced into the RBS Group, rather the risk profile of certain entities are changing.

In Sections 8.2.1 I have considered the immediate effect of the Scheme on risk management processes. In Section 8.2.2, I have considered broader risk management matters.

8.2.1 Risk Management – changes in risk profile

The change in risk profiles as a result of the Scheme will be managed by adjusting the current risk appetite and limits (used to monitor compliance with risk appetite) on a legal entity basis, to reflect the new risk profiles.

An overarching risk appetite will continue to be established at RBSG plc level, and allocated to functions, franchises and legal entities. Legal entity risk appetite statements will be set for all key regulated entities, and these will be aligned to the entities' business plans. Risk appetite statements are refreshed annually to reflect any changes to the risk profiles of the entities, and all risk appetite statements will have been re-calibrated by the date of the transfer to reflect the new risk profiles of the individual entities.

Compliance with the risk appetite will be monitored through the use of strategic risk limits such as capital adequacy, liquidity and funding, and material risk limits such as credit, operational and conduct. Strategic limits will be set and monitored at the legal entity level, whereas material risks will be monitored at the sub group level, split between the entities in the RFB Subgroup and the entities in the non ring-fenced group.

RBS is planning to use the existing internal board and committee reports going forward, these reports will be adjusted as required, to meet specific legal entity requirements.

8.2.2 Risk management – overall structure

The risk management structure of the RBS Group is being changed with reference to the wider ring-fencing requirements which have to be adhered to by 1 January 2019. There are a number of changes that are being made as a result which are currently being discussed with the regulatory authorities. These include:

- RBS plans to continue to use a functional approach to managing risk and conduct for entities within the ring-fence. There will be dedicated teams for each risk type: credit, market, operational, financial crime, enterprise-wide and assurance.
- Outside the ring-fence, NatWest Markets will have a separate risk and conduct function with a dedicated CRO and risk activities that are fully aligned to each licensed bank, including staff in non-EEA locations. Some supporting risk services will be provided by the RFB to the entities outside the ring-fence under arm's-length intra group agreements.
- There will be risk governance in place at the legal entity level and the franchise level, with each group being responsible for different elements of risk management. The roles and responsibilities will be clearly defined and set out in the terms of reference of the relevant boards, committees and forums.
- As part of the process of designing the new business operating models for both the RFB Subgroup and entities outside the ring-fence, the risk framework and all relevant policies will be reviewed to enable the business operating models to achieve the same standards of risk and control as at present, including additional policies to manage risks to customers arising from crossing the ring-fence.
- Business services and functions will continue to be provided through a consistent shared operating model, minimising duplication and demonstrating where appropriate business independence. The majority of risk staff will work for the RFB and be employed by NatWest Bank, with some providing services across the ring-fence, via intra group agreements. This includes staff within the shared services operated from within the RFB Subgroup.

Overall, having taken into account the changes planned, I do not consider there to be an Adverse Effect as a result of the Scheme from a risk management perspective.

8.3 Conclusion

For the reasons set out above, I am satisfied that there is no Adverse Effect as a result of the Scheme in respect of governance and risk management considerations.

9 Operational considerations

9.1 IT change

In this section, I consider the effect of the Scheme on the operation and support of RBS's IT systems and the changes being made to support the migration of a number of existing customer Derivative Transactions from NatWest Bank to NatWest Markets. In doing so I have assessed the potential effect on customers and the potential for customer or other Stakeholder detriment from the changes to IT services being implemented.

I have reviewed RBS plans in relation to IT changes arising from the Scheme to understand any significant changes in order to assess potential customer detriment as a result of these changes. This was performed through review of planning and design documentation and meetings with RBS staff.

My review of IT change activity focused in particular on the following areas:

- Review of plans to determine whether significant technological effects exist that may result in customer detriment, including consideration of data confidentiality, maintenance of service levels, and the availability and resilience of service in the context of the Scheme;
- The approach taken to derive and document requirements, and to develop the plans for implementation; and
- Review of the governance of the RFTS IT programme to determine whether it adequately supports the ability to identify relevant IT effects, and to execute and deliver against the plan.

Based on the above, I am satisfied that there is no Adverse Effect on IT services, arising from IT changes planned as a result of the Scheme. However, I note that as the two dress rehearsals and the Effective Date are scheduled after the date of this Scheme Report, the scope of my work is limited to the review of planning, design build, state of preparedness and governance in relation to the IT change required to support the transfer of the existing customer Derivative Transactions from NatWest Bank to NatWest Markets.

The programme of work has been designed to minimise the extent and effect of IT change required, and to continue to book trades within the same systems as currently. This approach aims to reduce the overall complexity of the IT design, which is commonly the largest driver of IT execution failure risk. In respect of the IT programme, I note that:

- As Derivative Transactions of NatWest Bank counterparties are booked in the same systems used by NatWest Markets there is no requirement for a system-related migration over the implementation weekend.
- For all trades in scope for migration over the implementation weekend (i.e. those customers that have not elected to opt-out), the migration will involve a two-step process of "legal entity migration and cancellation". This simple process involves the cancellation of the trade in the NatWest Bank portfolio and a rebooking of the trade in a NatWest Markets portfolio.
- As such, no data migration is due to occur and the trade migrations do not require technical system changes. The business processes being used to support migrations are well established and involve less risk and complexity than technical migrations.
- For opted-out Eligible Derivative Transactions, there is no requirement for any kind of migration (whether system, book or legal entity-related) over the course of the implementation weekend.
- The IT changes identified take the form of small updates to reference data to reflect new legal entity structures and ownership. These changes are in general simple with limited effect and can be characterised as routine business-as-usual type changes.

- Technology involvement in this Scheme is limited to support, with no technology development work required.
- RBS's IT function will not be restructured as part of the Scheme, and will maintain a continuity of service as it did prior to implementation of the Scheme. No effects are therefore expected to IT operations, level of service, resourcing or staffing as a direct consequence of the Scheme.
- The IT programme of work is being managed in accordance with RBS's standard programme and project management methodologies and governance processes which provide control over the full systems development process. The Scheme programme is supplemented by additional governance forums to ensure consistency and involvement from all affected franchises and functions. This is in addition to RBS's standard programme governance structures.
- Two Dress Rehearsal tests will be carried out in order to test the programme-wide implementation activity and the implementation weekend schedule of events. As these tests are scheduled to take place after the date of this Scheme Report, I will address them further in my Supplementary Report.

These factors support my assessment that the planned changes have limited potential effect for counterparties. Additionally, no specific risks to resilience, continuity or security of systems have been identified arising as a consequence of the Scheme.

I note that in order to comply with ring-fencing requirements, NatWest Bank will not be able to rely on NatWest markets systems and process after 1 January 2019. As a result a number of trade migrations and system changes will be made during 2018 after the Effective Date of the Scheme to ensure compliance with the requirements. This will include changes to existing systems and processes for Derivative Transactions that have been opted of the Scheme. RBS has plans to ensure that such changes will not have operational implications for such counterparties.

9.2 Operational support

9.2.1 Counterparties transferring to NatWest Markets

As the customer derivative business of NatWest Bank is moving to NatWest Markets, all operational support for this business will be provided by NatWest Markets following the Effective Date.

All transferring Derivative Transaction types are also currently offered by NatWest Markets, and as a result NatWest Markets will require no operational developments in order to receive and support the transferring population.

9.2.2 Counterparties electing to opt out

As the customer derivative business of NatWest Bank is moving to NatWest Markets and as NatWest Markets will sit outside the ring-fence, NatWest Bank will no longer be able to access the operational support provided by NatWest Markets after 1 January 2019.

To facilitate the ability to opt out of the Scheme, RBS has developed an operational plan for providing ongoing operational support for the remaining population.

Whilst no new customer derivative business will be originated by NatWest Bank going forward, any Derivative Transactions not transferring under the Scheme will need to be managed by NatWest Bank until the earlier of scheduled maturity or early termination of the Derivative Transactions. Currently, other than the transferring customer Derivative business, the only Derivative Transaction capability within NatWest Bank is the Treasury Markets function, which performs risk management for RBS. Treasury Markets will continue to execute and manage Risk Management Derivative Transactions, which, as mentioned in Section 3, are permitted to remain within the ring-fence.

Following the Effective Date, counterparties that have opted out Eligible Derivative Transactions will be informed of a new NatWest Bank contact to support the ongoing management of the opted out Derivative Transactions. Any counterparties that use Agile Markets will not be able to review live trade data for any Eligible Derivative Transactions that have been opted out of the Scheme. Ongoing support for these Derivative Transactions will be provided by the new NatWest Bank contacts, both in terms of provision of trade information or any requests for early termination. Users of Agile Markets will, however, still be able to view historic information for opted out trades.

There are certain other operational changes required in order for Treasury Markets to manage any opted out Derivative Transactions, such as amendments to certain regulatory trade volume reporting, and RBS will agree any changes with the relevant regulators prior to the Effective Date.

I am satisfied that RBS has a plan in place to maintain the opted out trades in NatWest Bank. The remaining trades will be supported by an established function of NatWest Bank, that any changes required to enable this support are not significant, and that the plans for these changes are in place.

9.3 Collateral

The operational implications for any collateral depend upon any election by a counterparty to use the opt-out.

If a counterparty transfers all Derivative Transactions under the Scheme then any collateral held by NatWest Bank will be transferred from NatWest Bank to NatWest Markets along with the governing title transfer collateral arrangement ("TTCA").

If a counterparty has only Eligible Derivative Transactions and elects to opt out of the Scheme, then any collateral and governing TTCA will remain with NatWest Bank.

For any counterparty that has both Ineligible Derivative Transactions and Eligible Derivative Transactions, and has elected to opt out the Eligible Derivative Transactions, RBS may need to split any collateral. Where the collateral is held by NatWest Bank, the collateral will be split proportionally in relation to transferring and non-transferring exposures, and NatWest Bank will transfer the relevant proportion of collateral to NatWest Markets. As the counterparty will still require a TTCA with NatWest Bank this will not be transferred, however the TTCA will be replicated in NatWest Markets to reflect the split exposure.

9.4 Conclusion

For the reasons set out above, I am satisfied that there is no Adverse Effect as a result of the Scheme in respect of operational considerations.

10 Resolvability considerations

10.1 Overview

This section considers whether any detriment to Stakeholders arises in relation to the resolvability of the Companies. Resolvability refers to the ability to deal with a failing bank in an orderly manner that does not use public funds and ensures that critical functions provided by a bank to the economy are not interrupted. Resolution is the process by which the authorities intervene to manage the failure of a bank; in the case of the RBS Group the BoE is the Resolution Authority. Planning for the resolution of all banks, including the RBS Group, is a key part of the post-financial crisis regulatory framework. Specific resolution decisions and actions are planned for and are only taken at the time of a crisis. These actions would determine the effect on the RBS Group, the Companies and Stakeholders.

I have considered whether the Scheme may result in detriment if Stakeholders are moved to a company which is (or will be) less resolvable, or the RBS Group as a whole is made less resolvable as a result of the Scheme. If Stakeholders are exposed to a less resolvable entity, they may face greater financial loss and/or operational disruption in the event of resolution than they would do were it not for the Scheme.

This section also considers whether any effect arises in relation to the ability to recover the Scheme Companies from a severe stress.

10.2 Recovery plan

A recovery plan is a regulatory requirement that is prepared by the RBS Group. It sets out how RBS Group monitors whether it is facing a severe stress, how it escalates and manages such a severe stress and the menu of actions it might take to try to return to business as usual. The RBS Group is required to assess the strength of the recovery plan against a number of hypothetical severe stresses.

The RBS Group currently produces a Group recovery plan. The Group recovery plan is reviewed by the PRA, which provides feedback for improvements in future iterations.

I have considered whether the Scheme will lead to a significant deterioration in the robustness of recovery planning.

The RBS Group proposes to maintain a Group recovery plan. There will be also be recovery frameworks covering both the RFB Subgroup and NatWest Markets. These will be developed by staff of the entity and/or sub-group and subject to their own Board approvals. A consistent structure will be used for each of the bank’s frameworks. A group-wide plan will also be prepared and will include specific group matters (such as group level options) and address the regulatory requirements of the recovery plan. All frameworks will be included in the group plan. The RBSG plc Board will be asked to approve the consolidated plan.

RBS does not expect any significant effect on the ability to execute recovery options under the current Group recovery plan as a result of the Scheme. Recovery will continue to be managed on a Group-wide basis. This is because most of the existing recovery options will sit either in the RFB Subgroup or in entities outside the ring-fence. Plans are being developed and implemented by RBS to manage the ability to move capital and liquidity across the RBS Group once ring-fencing legislation is in force; the same considerations that apply to day-to-day management of financial resources will apply in a recovery scenario. The PRA’s latest proposed group recovery plan requirements will not require RBS to prepare independent recovery plans for each subgroup.

On the basis that RBS's development of recovery planning is effective in facilitating movement of capital and liquidity across the RBS Group in compliance with ring-fencing requirements, I am satisfied that the Scheme does not cause an Adverse Effect on the ability of the Scheme Companies to recover from a severe stress.

10.3 Resolvability

As the Skilled Person, one of my considerations is the effect of the Scheme on the impact that would be felt by Stakeholders in the event that the RBS Group or any or all of the Companies were to go into resolution. Resolution – and the related concept of resolvability – refer to the powers and process by which the resolution authorities deal with a bank that has been assessed by the resolution authorities as failing or likely to fail, in the absence of credible recovery actions. Resolution is intended as an alternative to normal corporate insolvency.

Since the financial crisis regulators and banks globally have been working to put in place the legal powers and approaches that would enable even the largest banks to be put into resolution.

The Bank Recovery and Resolution Directive ("BRRD") took effect on 1 January 2016 with the policy intention of avoiding the need for public sector funds being used to support failing banks. It was implemented into UK law through a combination of secondary legislation, rules made by the PRA and policy made by the BoE. As the BoE UK's Resolution Authority, the BoE has a range of powers to intervene to manage the failure of a firm.

These resolution powers include the power to impose a 'bail-in' of certain liabilities of a bank. The BoE is able to write down and/or convert to equity the claims of shareholders and unsecured creditors, subject to various exclusions and with a mechanism to assess compensation after the bail-in. The bail-in is intended to re-capitalise the bank, avoid insolvency and buy time to restructure the bank and address its underlying problems.

As a Global Systemically Important Institution ("GSII"), the RBS Group would be subject to a bail-in strategy by the BoE if it were to go into resolution.

I have not sought to assess whether the RBS Group is or will be resolvable from a regulatory perspective. That is a complex judgement that sits outside the scope of my role as the Skilled Person and is properly the responsibility of the BoE as Resolution Authority. My focus is on whether the RBS Group or any of the Scheme Companies will become any less resolvable, such that by transferring, or not transferring, businesses between them, a Stakeholder may be exposed to an increased risk of a disorderly resolution, that is a greater monetary loss given default, or operational discontinuity that affects their ability to transact.

The overall strategy for the resolution of the RBS Group is not anticipated to change as a result of the implementation of the Scheme, though this is ultimately the decision of the BoE. It will remain a so-called 'Single Point of Entry' resolution that is undertaken Group-wide from RBSG plc downwards.

The first stage of the resolution would be to undertake a 'bail-in' that absorbs the losses that have pushed the bank into resolution. This is explained in more detail in Section 7. This is a crucial first step in stabilising the bank and recapitalising it. As concluded in Section 7, I am satisfied that no Adverse Effect arises as a result of the Scheme in that regard.

Once RBS has been stabilised, the BoE would appoint a Bail-In Administrator to lead the restructuring of the RBS Group. The BoE would be aiming to ensure as far as possible that there is Operational Continuity in Resolution ("OCIR") for customers and counterparties as far as possible, to avoid disruption to the real economy.

The RBS Group has an OCIR workstream underway, to comply with specific OCIR rules that come into effect on 1 January 2019. This is an ongoing programme that has a project plan for the period out to 2019. I have considered the overall approach being adopted by the RBS Group and have concluded that there is no Adverse Effect as a result of the Scheme.

The result of the OCIR programme is planned to be:

- A service catalogue: a detailed record of all the critical services provided within the RBS Group that are required operationally to run RBS's business.
- Service mapping: building on the service catalogue, RBS will have mapped the providers and recipients of those services. Mapping is being undertaken by legal entity and by 'Critical Economic Function,' that is the critical products and services provided to third parties.
- Legal agreements: RBS is putting in place a series of contractual arrangements to support the service catalogue and mapping. These are being drafted to ensure that services should continue uninterrupted in a resolution, subject to payment for services continuing to be made and set on an arm's-length basis.
- Financial resilience: the RBS Group is developing its ability to calculate the segregated funds amount for operational continuity funding required by the PRA from 1 January 2019, and is identifying the intra-group and third party arrangements in which the funds will be held.
- Governance: as part of the RBS Group's operating model design for the Shared Services Model there will be a framework for managing internal services across the RBS Group. This will include Intra-Group Agreements ("IGA") governing the supply of central services being signed by a senior executive or 'head of' function as Service Owner, who will be accountable for ensuring that the service is provided in line with the IGA.

The OCIR programme above is in process to ensure that RBS meet ring-fencing requirements included those that are linked towards resolvability. The Scheme results in businesses moving to different entities and RBS is including these changes in its overall mapping and linked activities that are occurring.

Although this overall programme will not be completed until the end of 2018, I do not consider that the Scheme has an Adverse Effect on the arrangements that do exist in the RBS Group as at the date of the Scheme.

10.4 Conclusion

For the reasons set out above, I am satisfied that there is no Adverse Effect as a result of the Scheme in respect of resolvability considerations.

11 Tax considerations

11.1 Introduction

In this Section, I consider the effect of the Scheme on the tax borne by NatWest Bank and NatWest Markets, potential tax costs for customers and other key Stakeholders and whether they may suffer an Adverse Effect as a result of the Scheme.

I have based my conclusions on information received from RBS, which I have reviewed and challenged. Overall I have concluded that, from a tax perspective, there are no Adverse Effects on customers or creditors of NatWest Bank and NatWest Markets as a result of the Scheme.

Although my review has not identified any Adverse Effects for customers and creditors, there will always be some risk of an adverse tax effect due to changes to tax legislation between now and the Effective Date of the Scheme, or in relation to execution risks (for example, the obtaining of tax clearances and notification requirements). I am not aware of any proposed legislative or tax changes that would have an adverse effect at the present time.

11.2 Corporation tax

The Scheme involves the transfer of certain Derivative Transaction assets and liabilities within a group under common ownership of RBSG plc for relevant corporation tax purposes. On the basis that all Derivative Transaction contracts are accounted for on a fair value basis by NatWest Bank, the transfer of the relevant asset/liability would be reflected at fair value by NatWest Bank, and NatWest Markets would be treated as acquiring the asset/liability at the same value.

Based on the above, the Scheme is not expected to give rise to a corporation tax charge for NatWest Bank or NatWest Markets.

11.3 VAT

The transfer of Derivative Transactions is expected to be exempt from VAT. In any case, the RBS UK corporate group operates in a UK VAT group, which currently includes NatWest Bank and NatWest Markets. Consequently, RBS expects the transfer of Derivative Transactions from NatWest Bank to NatWest Markets under the Scheme will be disregarded for UK VAT purposes.

11.4 Stamp duty and other transfer taxes

The Derivative Transaction contracts being transferred are not expected to be in the scope of UK stamp duty or stamp duty reserve tax. In any case, on the basis that NatWest Bank and NatWest Markets are under common ownership under RBSG plc, I am satisfied that there will be no UK stamp duty or related costs arising as a result of the Scheme as stamp duty group relief should be available subject to making a formal claim for relief to HMRC.

11.5 Customer taxation

RBS does not expect there to be an increased withholding tax burden for customers since NatWest Bank and NatWest Markets are both UK tax resident companies. RBS has obtained advice regarding procedural requirements (if any) to be followed in a counterparty's local jurisdiction in order to update withholding tax clearances to reflect the transfer of Derivative Transactions to NatWest Markets from NatWest Bank.

One area of potential Adverse Effect is whether the transfer of Derivative Transactions under the Scheme involves a Derivative Transaction counterparty being deemed for tax purposes to have disposed of their rights under the Derivative Transaction contract with NatWest Bank in consideration for new rights under a Derivative Transaction contract with NatWest Markets (a "realisation event"). Such a deemed disposal could potentially crystallise a tax charge for the counterparty. This will depend on the local tax rules of the jurisdiction in which the counterparty is tax resident and on the particular circumstances of the counterparty.

NatWest Bank has obtained tax advice which states that the Scheme should not be a realisation event for UK resident counterparties. Tax advice previously obtained by NatWest Markets for a number of non-UK resident counterparty jurisdictions (including some of those jurisdictions which NatWest Bank considers to be potentially relevant in the case of the Scheme) indicates that it is generally unlikely that a realisation event may be triggered by a scheme of this type – apart from in the US. No US counterparties have been identified in the case of the Scheme. There are a small number of jurisdictions where the risk identified is considered more than an immaterial risk due to a lack of tax authority guidance on the matter, albeit the advice obtained states that there are still good arguments that a scheme of this type should not give rise to a realisation event. Furthermore, the advice obtained does not indicate that the counterparties would need to file their tax returns on the basis that a scheme of this type is a realisation event.

NatWest Bank has identified potentially relevant counterparty jurisdictions for the Scheme based on the counterparty's country of incorporation. This includes additional jurisdictions where advice had not previously been sought, namely Ireland, Canada and Hungary. Advice obtained indicates that the Scheme should not constitute a realisation event for counterparties resident in Ireland or Hungary. In the case of Canada, the advice indicates that the Scheme is unlikely to constitute a realisation event in light of the legal effect of a scheme under Part VII of FSMA under the governing law of the contracts concerned, which is understood to be English or Scottish law.

It is not possible to identify all jurisdictions in which a counterparty may be tax resident or otherwise subject to tax. Whilst NatWest Bank has identified the jurisdiction of incorporation of the counterparties, this is not necessarily the same as the jurisdiction of tax residence in all cases. It is therefore possible that there are some counterparties which are resident or otherwise subject to tax in a jurisdiction in which neither NatWest Markets nor NatWest Bank has obtained advice. Even if a realisation event was deemed to arise in a particular jurisdiction, there are a number of other factors which would be needed for a potential Adverse Effect to arise from a corporate income tax perspective. Firstly, generally the Derivative Transaction must be "in the money" from the counterparty's perspective, i.e. the value of its rights under the contract must exceed the value of its liabilities, in order for there to be a taxable profit. The counterparty also needs to be taxed on a realisation basis and not on a fair value basis, i.e. where the counterparty is taxed on increases in value on the Derivative Transaction irrespective of whether a realisation event arises. In many jurisdictions, Derivative Transactions to which companies are party are not taxed on a realisation basis. Furthermore, for an Adverse Effect to arise, a counterparty's own tax position and their local jurisdiction's tax rules would need to be such that the counterparty could not offset the deemed taxable income on a realisation event with certain losses or other attributes for tax purposes.

I also note that RBS will offer counterparties the right to terminate Derivative Transaction contracts at market value thereby providing a mechanism to realise a gain with which to settle any tax that may be payable.

Based on the above, I am satisfied that the approach taken by RBS is a reasonable one and as changes to the tax circumstances of a Derivative Transaction counterparties involved in the Scheme are unlikely to occur, I do not expect the Scheme to cause any Adverse Effects from a tax perspective.

11.6 Conclusion

For the reasons set out above, I am satisfied that there is no Adverse Effect as a result of the Scheme in respect of Tax considerations.

12 Communications

12.1 Introduction

RBS must satisfy the Court as to the adequacy of its communications plan. In addition, RBS must comply with specific notice requirements issued by the Court concerning the Scheme, which will be determined at the First Hearing. RBS will follow the approach to communications set out in the PRA Statement of Policy and the FCA Guidance, and the present practice of the Court in relation to RFTSs and other transfers under Part VII of FSMA.

I outline below RBS's proposed communication plan and whether, in my view, any persons likely to consider themselves to be adversely affected by the Scheme will receive information on the proposed Scheme which is clear, fair and not misleading, in line with Principle 7 of the FCA Handbook.

My review of Scheme communications is based on RBS plans and draft notifications prepared as at the date of this Scheme Report.

12.2 Court requirements

In order to satisfy the Court, RBS's communications plan must encompass any person or party who may consider themselves to be adversely affected by the Scheme.

The Court also requires that the period for raising formal objections to the Scheme is within 42 calendar days after the date on which the last Gazette notice is published. The publication of the advertisements for the Scheme is to be approved by the Court at the First Hearing.

12.3 Regulatory requirements

The PRA Statement of Policy notes that a key concern for the PRA will be to satisfy itself that persons other than the Transferor have adequate information and a reasonable time within which to determine whether or not they are adversely affected and, if adversely affected, whether to make representations to Court.

An important focus for RBS is the FCA's Principle 7, "*Communications with Clients: A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.*"

The FCA Guidance expects that customers and counterparties of RBS likely to be affected by the Scheme are notified of the Scheme. Such notifications should summarise the changes proposed under the Scheme, how the Scheme is likely to affect them, how further information on the Scheme can be obtained and the process for making written representations regarding the Scheme (including raising objections).

The FCA Guidance further states that a firm should consider giving notice of the application for a RFTS in one or more of the following ways: publication in the official Gazettes and at least two national newspapers in the United Kingdom (normally two newspapers, but wider publication may be appropriate in some circumstances) and individually sent notices to all consumers who are likely to be adversely affected by the Scheme. In addition, the FCA notes that it is normally appropriate for the following documents to be made available, free of charge to anyone requesting them: a statement setting out the terms of the Scheme, a summary of this Scheme Report and a copy of the full Scheme Report.

The PRA and the FCA are engaging closely with RBS on their requirements for communications on the Scheme and RBS has been consulting with the PRA and FCA on the Regulators' views about what communication might be appropriate.

12.4 Notification of the Scheme

12.4.1 Communication plan

RBS plans to inform counterparties and other Stakeholders of details of this Scheme through a combination of direct and indirect communications.

RBS intends to give notice individually, by both letter and email, to all counterparties intended to be transferred to NatWest Markets as a result of the Scheme. RBS plans for the customer mailing process to be undertaken immediately after the First Hearing.

RBS does not plan to individually notify all customers and counterparties of NatWest Bank. As only a very small, discrete part of NatWest Bank's business will be moving to NatWest Markets, the Scheme will not affect other services provided by NatWest Bank to its existing customers and counterparties. RBS considers that notification to all NatWest Bank customers may create unnecessary concern and confusion.

Similarly RBS does not plan to notify customers of NatWest Markets because only a very small, discrete part of NatWest Bank's business will be moving to NatWest Markets and the Scheme will not affect other services provided by NatWest Markets to its existing customers and counterparties.

I am satisfied that these decisions are reasonable considering the size and nature of this Scheme.

RBS will also give notification of the Scheme via a company announcement. Counterparties of RBS may also be notified through clearing systems such as SWIFT. Information about the Scheme will also be included on the RBS website.

Notice of the Scheme application will be published in the London, Edinburgh and Belfast Gazettes. Notice will also be published in The Scotsman and the Financial Times (UK and international editions). These notices will include details of the date of the Final Hearing, how to obtain further information on the Scheme and the process for raising objections to the Scheme.

The proposed Scheme notifications have been through RBS review and governance processes.

12.4.2 Scheme information

RBS will include on its main website at **www.rbs.com/ring-fencing** the following documents relating to the Scheme:

- the Scheme Document and a summary of the principal terms of the Scheme;
- the advertisement giving notice of the Scheme;
- the petition to the Court in relation to the Scheme;
- this Scheme Report and my Summary Scheme Report; and
- any Supplementary Reports that I may produce.

This information for customers will also be available at **www.natwestmarkets.com** and **www.natwest.com**.

RBS will provide a hard copy of all of these documents upon request, free of charge.

General information on RBS ring-fencing plans is already available at this website and contains links to previous RBS announcements on its implementation of ring-fencing and to the FCA website.

Counterparties can contact their relationship managers for more information, and RBS intends to establish a dedicated helpdesk for counterparties who have queries on matters such as RFI classification.

RBS is preparing internal communications to inform and equip staff with information about the Scheme should customers and counterparties raise questions or queries. Guidance is also being prepared by RBS on the process for handling objections and complaints, and how these will be logged.

12.4.3 Direct communications

RBS intends to notify all counterparties intended to be transferred from NatWest Bank to NatWest Markets as a result of the Scheme, providing information on:

- Why RBS is undertaking the Scheme and what the Scheme entails;
- How the Scheme affects them and the immediate impact of the Scheme on them;
- What documents relating to the Scheme are available and how to obtain them online or in hard copy;
- How to find out more information on the proposed Scheme or raise any questions;
- Key dates for the Scheme, including the date of the Final Hearing and proposed Effective Date; and
- The process and timeline for raising objections to the Scheme.

The Scheme involves the transfer of a small volume of business, directly affecting approximately 3,000 customers and counterparties. RBS maintains databases on which customer information is held, from which it is able to identify persons to be included in the Scheme notification.

12.4.3.1 Existing counterparties

RBS's draft communications include information applicable to specific situations where the Scheme causes a change in customer circumstances. These circumstances include changes in protection available to customers such as rights of set-off, and required amendments to contractual rights to give full effect to the Scheme. In particular, the communications will include information relating to:

- Administrative changes to documentation and the delivery of certain services introduced by the Scheme, affecting customers or counterparties;
- The creation of new or enhanced set-off rights for RBS together with details of the mitigation proposed by RBS;
- Treatments of claims or legal proceedings against NatWest Bank; and
- Ability for customers and counterparties to elect to opt out of the Scheme.

12.4.3.2 New business

RBS's response to requests for new business will be depend upon the specific circumstances of the counterparty.

Any existing Derivative Transaction counterparty of NatWest Bank who wishes to execute a Derivative Transaction after the First Hearing but before the opt out cut-off date will be able to trade with NatWest Bank and will be able to opt out of the Scheme in respect of their Eligible Derivative Transactions.

Any existing Derivative Transaction counterparty of NatWest Bank who wishes to execute a Derivative Transaction after the opt out cut-off date but before the Effective Date will be able to trade with NatWest Bank but such Derivative Transactions will not be eligible for opt out and will

move to NatWest Markets under the Scheme. This information will be contained in the Scheme communications.

For any existing banking customer of NatWest Bank who wishes to execute a Derivative Transaction with RBS for the first time, the approach will depend on when they wish to execute the trade.

- Up to the opt out cut-off date, they will be informed that they can enter into a Derivative Transaction with NatWest Bank and will be able to opt out of the Scheme in respect of their eligible Derivative Transactions only;
- Between the opt out cut-off date and the Effective Date, counterparties will be informed that they can either trade with NatWest Bank with the understanding that the Derivative Transactions will transfer to NatWest Markets under the Scheme, or they can trade with NatWest Markets;

Any customers that are new to RBS who wish only to trade Derivative Transactions will be offered the ability to trade with NatWest Markets only. Any new customer that wishes to open both a Derivative Transaction and banking relationship will be offered banking facilities with NatWest Bank and Derivative Transaction services with NatWest Markets.

12.4.3.3 Vulnerable customers

For customers whose personal circumstances require communications to be undertaken in a different way, for example if they are going through a temporary or permanent specific life event such as having a disability, dealing with bereavement or working through debt, RBS will implement its Customers in Vulnerable Situations policy and ensure staff are properly trained and understand their roles and responsibilities in dealing with vulnerable customers. Provision will also be made for customers with special needs or in vulnerable situations.

Customers identified as being in a vulnerable position will be supported by their relationship manager throughout the process. This may include in addition to the above, customers in restructuring or collections and customers where a Power of Attorney is in use.

I have relied on the exercise performed by the RBS Group to identify customers affected by specific issues. I have enquired into this process and have asked the RBS Group to explain, check and/or clarify any results that seemed to me unreasonable or inconsistent with other data and information. All such queries have been answered to my satisfaction.

I am satisfied that the planned notifications and support to persons affected by the Scheme are reasonable.

12.4.4 Uncontactable customers and counterparties

In any group mailing exercise there is a risk that some correspondence details may be out of date, and as a result some mailings may not reach the intended recipient. RBS has performed a review and test of counterparty correspondence details in order to improve data accuracy and the effectiveness of the Scheme mailing. RBS also intends to communicate with all counterparties by letter and email in order to increase the chances of successful delivery.

RBS will rely on extensive advertising and the use of the RBS website as described in Section 12.4.2 to give notice to customers and counterparties RBS is unable to reach by individual communication.

12.4.5 Review of draft communications

I have reviewed drafts of RBS's proposed communication materials available at the date of this Scheme Report.

- I am satisfied that the proposed communication materials provide sufficient information to enable customers and counterparties to understand what is changing under the Scheme, the implications of the Scheme and the effect on their business, services and relationship with RBS, and the objections process to follow should they consider themselves adversely affected.
- I am satisfied that the proposed communication materials provide sufficient information on the opt out process, including details on how to get further information and the process to follow should they wish to exercise those rights.
- I am satisfied that the proposed communication materials provide sufficient information on the option to terminate existing Derivative Transactions, including details on how to get further information and the process to follow should they wish to exercise those rights.
- I am satisfied that the communications are as clear as they can be given the message which needs to be communicated.
- I am satisfied that the process to obtain additional information on the Scheme, if required, is simple and clearly communicated. Information on the Scheme will be predominantly internet-based, and it will be clear to the customer how to access or download information on the Scheme. I have also reviewed and am satisfied that there are appropriate provisions for customers and counterparties who do not wish to or do not have access to email or the internet. Such customers and counterparties can contact RBS regarding the Scheme by phone or put their request in writing.
- I have been provided with a draft of the proposed advertisement to be placed in certain newspapers in Scotland and the rest of the UK. It provides sufficient notice of the Scheme, the date of the Final Hearing and the Effective Date, where to obtain further information and the process and timeline for raising objections.

12.5 Opting out of the Scheme

As described in Section 5, RBS will give counterparties the opportunity to exclude Eligible Derivative Transactions from the Scheme.

The booklet included in the direct mailing will include an explanation of the opt-out process, key considerations for the counterparty, and definitions and examples of Eligible and Ineligible Derivative Transactions.

Counterparties who would like to exercise this opt out must notify RBS in writing by completing an opt-out notice and returning it by email or post no later than 5pm UK time on 18 June 2018. This opt-out notice will be included in the communications pack.

RBS has put into place a process to support counterparties who wish to opt out of the Scheme. A helpdesk will be available to support the opt-out process from the date of the First Hearing until the Effective Date. RBS is preparing internal communications to inform and equip staff dealing with questions or queries on whether customers or counterparties have Derivative Transactions eligible for opt out, the relevant information for the decision whether to opt out and the process opting out. Guidance is also being prepared by RBS on the process for handling requests to opt out, and how these will be logged.

Once a request to opt out has been received, RBS will perform a review of a counterparty's Derivative Transactions and determine if any are eligible for opting out of the Scheme. RBS will then inform the counterparty of whether they are eligible for opting out, which Derivative Transactions can be opted out, and an explanation on how RBS has reached its decision. RBS intends to respond to all counterparties requesting an opt-out by 4 July 2018. The RBS helpdesk will then contact any counterparty with both Eligible and Ineligible Derivative Transactions to ensure their understanding of the opt-out process and the implications of electing to opt out, and provide an opportunity for customers to confirm or withdraw their election.

Once customers have confirmed their intent to opt out, RBS will send a confirmation by email or in writing. Customers who wish to challenge the decision can contact the helpdesk by email up until 11 July 2018 and will be offered an explanation as to why the relevant decision was made.

I have discussed the overall timetable of the opt out process with RBS, and in particular the relatively short timetable between the latest opt out decision notification from RBS of the 4 July 2018 and the objections date of the 11 July 2018. As RBS is currently in the process of determining opt out eligibility for the existing Derivative Transaction population and hence expect to be able to respond to opt out requests on a timely basis, the timetable appears reasonable.

12.6 Termination or novation of Derivative Transactions

As detailed in Section 5, RBS will also offer counterparties the option to terminate Derivative Transactions at market value or novate the Derivative Transactions to a third party. This offer and how to exercise it will be set out in the communications sent to all counterparties.

12.7 Objections

If any person thinks that they would be adversely affected by the carrying out of the Scheme, they have two alternative ways of making sure the Court considers their views.

12.7.1 Lodging objections with the Court

They have the right to lodge formal written objections (known as "Answers") with the Court. If they wish to lodge Answers, they should seek independent legal advice. Answers are a formal Court document which must comply with the rules of the Court and are normally prepared by Scottish legal counsel. Answers must be lodged with the Court at Parliament House, Parliament Square, Edinburgh EH1 1RQ, within 42 days of the publication of the last of the notices relating to the Scheme, which is expected to be on or around 18 May 2018. The deadline for lodging Answers is 29 June 2018. In addition, Answers must also be accompanied by a fee to the Court.

12.7.2 Objections in writing or in person

The Court will also consider any other informal objections to the Scheme which are made in writing or in person at the Final Hearing. If a person wishes to object in writing or in person at that hearing, they need to send a written statement of their views to all of the following:

- by post or by hand to the Court at Parliament House, Parliament Square, Edinburgh EH1 1RQ;
- National Westminster Bank Plc, either:
 - by post or by hand to 250 Bishopsgate, London, EC2M 4AA; or
 - by email to ringfencing@natwestmarkets.com; and
- the Prudential Regulation Authority, either:
 - by post or by hand to National Westminster Bank, Prudential Regulation Authority, Bank of England, Threadneedle Street, London EC2R 8AH; or
 - by submitting it online at <http://www.bankofengland.co.uk/pru/Pages/authorisations/structuralreform/representations.aspx>

This must be done by 5pm UK time on 11 July 2018 in order to ensure the Court will consider their objection. No fee is payable to the Court for objecting in this way.

The Court is also likely to consider any objections made in writing after this date or in person at the Final Hearing, although it might not do so if the process described above has not been followed.

12.7.3 Consideration of objections by the skilled person

I will consider all objections that have been made up to the date of the Final Hearing in coming to my final view on the effect of the Scheme, and will address them where possible in my Supplementary Report.

12.8 Conclusion

I am satisfied that persons likely to be affected by the Scheme have been properly included in RBS's planned notification of the Scheme.

Subject to review of any changes to the proposed notification plans or communication materials, I am satisfied that the proposed notifications and communication of the Scheme are reasonable and are set out in in way that is clear, fair and not misleading.

I am satisfied that RBS's planned communications will be provided in a timely manner to inform persons likely to be affected by the Scheme of the process to request termination or opt-out. It will also inform persons likely to be affected by the Scheme of the process make representations or object to the Scheme.

Appendix 1 - Glossary

| Term | Means |
|--|--|
| Adverse Effect | Has the meaning as described in section 1.4 of this Scheme Report |
| Agile Markets | An electronic web-based interface with RBS that allows counterparties to transact business with it in a range of FX Derivative Transactions. |
| Answers | Formal written objections lodged with the Court at; Parliament House, Parliament Square, Edinburgh EH1 1RQ, by 29 June 2018 |
| Available Stable Funding or ASF | The portion of capital and liabilities that are classified as stable over a one year period |
| Bail-in | In a bail-in, the claims of shareholders and unsecured creditors of the failed firm are written down and/or converted into equity in order to absorb the losses and recapitalise the firm or its successor. |
| Bail-in Administrator | A bail-in administrator may be appointed by the Bank of England to manage the process of bail-in and manage the bank which is under resolution |
| Board | The board of directors of the relevant entity from time to time |
| BoE | Bank of England |
| BRRD | EU Banking Recovery and Resolution Directive 2014/59/EU |
| Capital Support Deed or CSD | A capital support deed is an agreement, under which the participating entities may be required to provide capital support to each other by means of distributions on, or repurchase or redeem, their ordinary shares. This obligation is limited to amounts in excess of a participant’s required regulatory capital requirements. |
| Capital Conservation Buffer or CCB | The capital conservation buffer is a capital buffer of 2.5% of a bank’s total exposures that needs to be met with an additional amount of Common Equity Tier 1 capital. |
| Countercyclical Capital Buffer or CCyB | The Basel III countercyclical capital buffer is calculated as the weighted average of the buffers in effect in the jurisdictions to which banks have a credit exposure. It is implemented as an extension of the capital conservation buffer. |

| Term | Means |
|------------------------------------|--|
| CET1 | Common Equity Tier 1 is the highest quality of capital. This is comprised of ordinary shares and reserves, less certain regulatory adjustments and deductions. |
| Companies | RBSG plc, NatWest Bank and NatWest Markets |
| Core Deposit | Deposits as defined under Article 2(2) The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014, which under the ring-fencing regulations are required to be provided by a ring-fenced body within a UK banking group in scope of the legislation. These are deposits within a bank account located in the EEA principally held by individuals and small businesses. Deposits comprise products such as current accounts, instant access savings accounts, fixed term savings, children's savings accounts, junior ISAs, and instant access and fixed term ISAs |
| Court | The Court of Session in Scotland |
| Coutts | Coutts & Company, a company incorporated in England and Wales with company number 36695 |
| Covered Bonds Business | Debt security instruments that are secured on an underlying pool of assets, typically mortgage loans or public-sector debt |
| Credit Support Annex | Provides credit protection by setting forth the rules governing the mutual posting of collateral. The main purpose of a Credit Support Annex is to regulate the collateral held by two parties entering into an ISDA master agreement. |
| Credit Valuation Adjustment or CVA | An adjustment made when calculating the fair value of a Derivative Transaction to ensure that the risk of default of the counterparty to the transaction is incorporated into the fair valuation of the Derivative Transaction. |
| Deloitte | Deloitte LLP |
| Derivative Transaction | A transaction entered into under an ISDA Master Agreement or equivalent agreement, which is a contract between two or more parties where the value of the contract is determined by fluctuations in one or more underlying assets. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes. |
| DoLSub | A group of two or more banks, within the same banking group, regulated and supervised as a single subgroup for liquidity purposes rather than on an individual basis. |
| D-SRB | Domestic Systemic Risk Buffer |

| Term | Means |
|---|---|
| Effective Date | Expected to be 00:01 on 13 August 2018 |
| EEA | European Economic Area |
| Eligible Derivative Transactions | Derivative Transactions which satisfy the criteria set out in Articles 9, 10, 11 and 12 of the EAPO and are therefore permitted for ring-fenced banks. Also includes prohibited Interest Rate Derivative Transactions that satisfy the 'Grandfathering' provisions. |
| Excluded Activities and Prohibitions Order 2014 or EAPO | The Financial Services and Markets Act 2000 (Excluded Activities Prohibitions) Order 2014 as amended by the Financial Markets Act 2000 (Ring-fenced Bodies, Core Activities, Excluded Activities and Prohibitions) (Amendment) Order 2016 |
| Excluded Activity | Activity prohibited in the RFB |
| Excluded Derivative Transaction | Any Derivative Transaction maturing after the Effective Date but prior to 31 August 2018 |
| Existing NWM Customers | Existing customers and counterparties of NatWest Markets |
| FCA | The Financial Conduct Authority or such successor governmental department, regulatory authority or other official body from time to time exercising supervisory powers in relation to financial services in the UK |
| FCA Guidance | FCA Finalised Guidance 16/1 "Guidance on the FCA's approach to the implementation of ring-fencing and ring-fencing transfer schemes" published in March 2016 |
| Final Hearing | The hearing at the Court at which the final decision whether or not to approve the Scheme is made |
| First Hearing | The preliminary hearing at the Court of the application relating to the Scheme |
| First Scheme | The transfer of business from NatWest Markets to RBS plc and NatWest Bank under Section 106B of FSMA, approved by the Court on 22 March 2018. |
| FSMA | The Financial Services and Markets Act 2000 |
| FX | Foreign exchange |

| Term | Means |
|------------------------------------|--|
| Grandfathering Provisions | <p>The provisions of Article 21 of the EAPO which is a transitional provision stating that a ring-fenced body does not carry on an excluded activity or contravene a prohibition imposed by the EAPO by holding or selling any investments on or after 1st January 2019 provided that:</p> <ul style="list-style-type: none"> • The investment in question was created or acquired by the ring-fence body before 1st January 2019; and • The period remaining until the investment matures is less than two years at 1st January 2019. |
| G-SIB | Global Systemically Importance Buffer |
| G-SII | Global Systemically Important Institution |
| Hedge Accounting | An accounting tool that allows an entity, when it has entered into a hedging transaction, to eliminate or reduce the income statement volatility that otherwise would arise if the hedged item and the hedging instrument were accounted for separately, without regard to the hedge's business purpose. |
| HQLA | High Quality Liquid Assets are securities that are deemed to be easily and immediately converted into cash in private markets, and include government bonds and other securities. |
| ICAEW | The Institute of Chartered Accountants in England and Wales |
| ICB | The Independent Commission on Banking inquiry of the UK government which looked at structural and related non-structural reforms to the UK banking sector to promote financial stability and competition in the wake 2007-2008 financial crisis. One of the ICB's key recommendations was that British banks should 'ring-fence' their retail banking divisions from their investment banking arms to safeguard against riskier banking activities. |
| Ineligible Derivative Transactions | Derivative Transactions other than Eligible Derivative Transactions |
| ISDA | The International Swaps and Derivatives Association which is a trade organisation of participants in the market for over-the-counter Derivative Transactions |
| ISDA Master Agreements | The ISDA Master Agreement is a commonly used master service agreement for over-the-counter (OTC) Derivative Transactions internationally. It is part of a framework of documents, designed to enable OTC Derivative Transactions to be documented fully and flexibly. The ISDA Master Agreement is published by the International Swaps and Derivatives Association. |

| Term | Means |
|----------------------------------|--|
| LCR | Liquidity Coverage Ratio is a measure of the ability of a bank to cover the net cash outflows that would experience under a stress scenario over the next thirty calendar days with a pool of defined High Quality Liquid Assets. |
| Leverage | The use of debt, instead of equity, in order to finance the purchase of assets and other investments. |
| Leverage Ratio | Leverage Ratio represents the bank's Tier 1 capital divided by its Total Exposure Measure or TEM with this ratio expressed as a percentage. |
| MREL | Minimum Requirement For Own Funds and Eligible Liabilities: The minimum level of financial resources to be held by each EU bank to absorb losses and recapitalise the continuing business in the event of Resolution. |
| NatWest Holdings | NatWest Holdings Limited, the intermediate holding company heading up the RFB Subgroup and is registered in England and Wales with registration number 10142224 |
| NatWest Bank or NWB | National Westminster Bank Plc which is a licensed bank registered in England and Wales with registration number 929027 |
| NatWest Markets or NWM | NatWest Markets Plc, which is a licensed bank registered in Scotland with registration number SC090312. NatWest Markets Plc was previously named The Royal Bank of Scotland plc. |
| NatWest Markets Franchise | NatWest Markets is the marketing and trading name under which RBS operates its financing, risk management and trading solutions businesses within RBS |
| Net Stable Funding Ratio or NSFR | A measure of resilience of banks over the medium-term and requires banks to maintain more stable sources of funding over the long-term and avoid the mismatch and reliance of funding long-term assets with short-term liabilities |
| Netting | Offsetting the value of multiple positions or payments due to be exchanged between two or more parties. It can be used to determine which party is owed remuneration in a multiparty agreement |
| Netting Set | A group of transactions with a single counterparty that are subject to a legally enforceable bilateral netting arrangement |
| NRFB | Non Ring-fenced Body or Non Ring-fenced Bank |
| OCIR | Operational Continuity in Resolution |

| Term | Means |
|---------------------------------------|--|
| OTC | Over-The-Counter is a security traded in some context other than on a formal exchange |
| Pillar 1 capital requirements | Set of requirements defining the amount of capital that banks need to hold at all times to cover unexpected credit losses for credit risk, market risk and operational risk. |
| Pillar 2A capital requirements | Set of regulatory requirements, additional to Pillar 1 capital requirements, defining the amount of capital that banks need to hold at all times aimed to address risks not fully captured in Pillar 1. As opposed to Pillar 1 requirements, Pillar 2A capital requirements are firm-specific and are calibrated by the PRA. |
| PRA | The Prudential Regulation Authority or such successor governmental department, regulatory authority or other official body from time to time exercising prudential regulatory and supervisory powers in relation to financial services in the UK |
| PRA Statement of Policy | PRA Statement of Policy "The implementation of ring-fencing: the PRA's approach to ring-fencing transfer schemes" published in March 2016 |
| RBS or RBS Group | RBSG plc and its subsidiaries and subsidiary undertakings |
| RBS plc | The Royal Bank of Scotland plc, which is a licensed bank registered in Scotland with registration number SC083026. RBS plc was previously named Adam & Company PLC. |
| RBSG plc | The Royal Bank of Scotland Group plc, which is the ultimate parent company of the RBS Group and is registered in Scotland with registration number SC045551 |
| RBSI | The Royal Bank of Scotland International Limited, which is a licensed bank registered in Jersey with registration number 2304 |
| Regulators | Together the PRA and the FCA |
| Relevant Financial Institution or RFI | Relevant Financial Institution as defined in Article 2 of EAPO, which comprises broadly financial institutions, such as non ring-fenced banks, investment firms, investment funds and managers thereof. RFIs do not include other ring-fenced banks or building societies. |
| Remaining NWB Customers | Remaining customers and counterparties of NatWest Bank |

| Term | Means |
|---|---|
| Required Stable Funding or RSF | The portion of capital and liability that is necessary, dependent on the liquidity risk characteristics of the different assets that a bank holds |
| Residual Asset | An asset transferring under the Scheme which does not transfer until after required formalities have been completed or approvals have been obtained. |
| Residual Liability | A liability transferring under the Scheme which does not transfer until after required formalities have been completed or approvals have been obtained. |
| Resolution | The status of a financial institution triggered by regulatory authorities when it has reached a point of non-viability and needs to be resolved under the direction of the authorities |
| RFB | Ring-fenced Body, i.e. a ring-fenced bank |
| RFB Risk Management Derivative Transactions | Derivative Transactions held by the RFB which are used for its own risk management purposes |
| RFB Subgroup | The ring-fenced sub-group of companies comprising NatWest Holdings and its subsidiaries and subsidiary undertakings |
| RFTS | A ring-fencing transfer scheme under Part VII of FSMA |
| Risk Appetite | The level of risk that an organisation is prepared to accept in pursuit of its objectives, and before action is deemed necessary to reduce the risk. Risk Appetite limits are applied to a number of areas of the business, which are monitored on an ongoing basis. |
| RWA | Risk-Weighted Assets are used to determine the minimum amount of capital that must be held by banks. It is calculated by assigning "weights" to the bank's assets reflecting the probability that such assets generate losses in relation to credit risk, counterparty credit risk, market risk and operational risk. |
| Scheme | The proposed transfer of business from NatWest Bank to NatWest Markets under Section 106B of FSMA, in its present form or with any modification thereof, or addition thereto, or condition approved or imposed by the Court. |
| Scheme Companies | The companies participating in the Scheme; namely NatWest Bank and NatWest Markets |
| Scheme Document | A detailed description of the terms of the Scheme |

| Term | Means |
|---|---|
| Scheme Report | The report on the Scheme prepared by the Skilled Person pursuant to Section 109A of FSMA and submitted to the Court to assist the Court in its decision whether or not to approve the Scheme |
| Scheme Reports | Supplementary Report and the Scheme Report |
| Secured Empty Arrangement | Any ISDA Master Agreement or "Agile Markets" terms of business between NatWest Bank and a counterparty where there are no live transactions at the Effective Date, but where there is an all monies security arrangement in place. |
| Skilled person | Oliver Grundy of Deloitte LLP whose appointment has been approved by the Regulators. The skilled person and Deloitte LLP has prepared Scheme Report pursuant to Section 109A of FSMA. |
| Stakeholders | All persons potentially affected by the Scheme including depositors, customers, counterparties and other affected persons |
| Standalone Derivative Transactions | Derivative Transactions not covered by a master agreement |
| Standard Settlement Instructions or SSI | Agreements between two financial institutions which fix the receiving agents of each counterparty in ordinary trades |
| Statutory Question | The question that the Scheme Report must specifically address, required under Section 109A of FSMA 2000. Namely whether persons other than the Transferor are likely to be adversely affected by the RFTS and if so whether the adverse effect is likely to be greater than is reasonably necessary |
| Subsequent Transfer Date | The relevant date of the transfer of a Residual Asset or a Residual Liability, which is after the Effective Date |
| Summary Scheme Report | A summary of the Scheme Report |
| Supplementary Report | A report produced in advance of the Final Hearing, to consider the effect on the Skilled Person's conclusions of events that have happened subsequent to the release of the Scheme Report. |
| Tier 1 capital | Tier 1 capital is comprised of Common Equity Tier 1 capital and Additional Tier 1 capital. Core Tier 1 capital is mainly comprised of ordinary shares and reserves less certain regulatory adjustments and deductions. Additional Tier 1 capital include perpetual subordinated debt instruments with conversion features |

| Term | Means |
|-----------------------------|--|
| Tier 2 capital | Tier 2 capital consists of other, non-equity types of investment in a bank and are generally less permanent in nature. These instruments are designed to increase the ability of a bank to absorb losses. Examples of Tier 2 capital include corporate bonds and other long term debt issued by the bank, which may be subordinated to all other debt owed by the bank |
| TLAC | The amount of loss absorbing capacity required to be held by global systemically important banks in the form of capital and eligible liabilities, in order to absorb losses and recapitalise banks in the event of Resolution |
| Total Exposure Measure | Total Exposure Measure for the Leverage Ratio represents the sum of the total value of the bank's total assets with some additional adjustments to account, for example, for certain exposures that are not accounted in the balance sheet |
| Transferor | NatWest Bank |
| Transferring Counterparties | Counterparties in respect of their business transferring from NatWest Bank to NatWest Markets under the Scheme |
| TUPE Regulations | Transfer of Undertakings (Protection of Employment) Regulations 2006 |
| Ulster Bank | Ulster Bank Limited, which is a licensed bank registered in Northern Ireland with registration number R0000733 |

Appendix 2 - Company Background

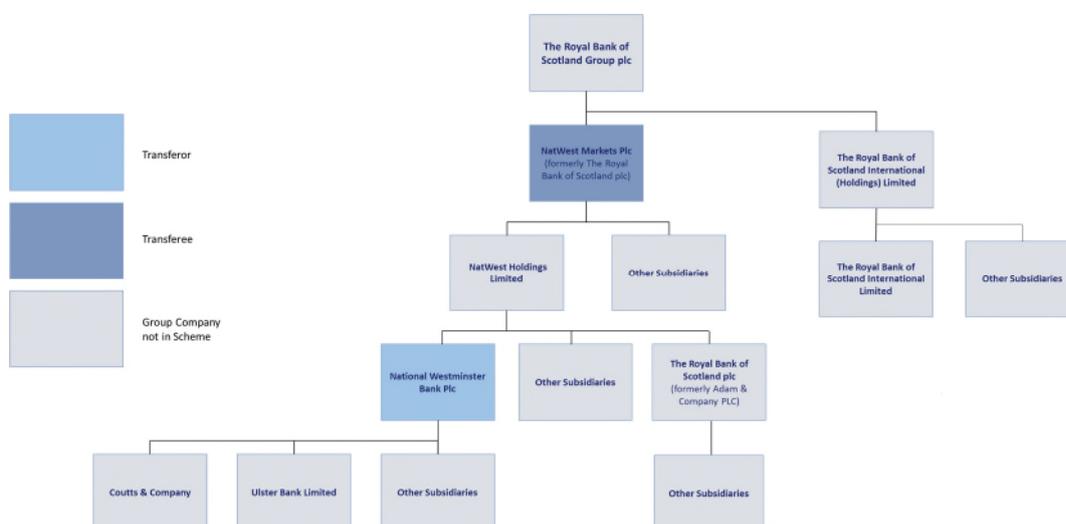
1. The Royal Bank of Scotland Group plc (“RBSG plc”)

1.1 Introduction

RBSG plc was founded in 1968 and has its registered office at 36 St Andrew Square, Edinburgh EH2 2YB. RBSG plc operates as the holding company for the RBS Group.

1.2 Corporate structure

Simplified legal entity structure



Source: Management information provided by RBS

1.3 Nature of business of RBSG plc

RBSG plc is the holding company of the RBS Group. The RBS Group provides a wide range of products and services to personal, commercial and large corporate and institutional customers through its three main subsidiaries, NatWest Markets, NatWest Bank and RBS plc (formerly Adam & Company PLC), as well as through a number of other well-known brands including Ulster Bank and Coutts.

2. Background to National Westminster Bank Plc

2.1 Introduction

NatWest Bank was established in 1968 by the merger of National Provincial Bank and Westminster Bank and has its registered office at 135 Bishopsgate EC2M 3UR. NatWest Bank was acquired by RBS in 2000 and is one of the retail banking arms of RBS Group. NatWest Bank provides a range of banking services and other financial products to personal, commercial and large corporate and institutional customers in the UK. NatWest Bank also has operations in Europe and the USA.

NatWest Bank is a wholly-owned subsidiary of NatWest Markets.

2.2 Nature of business of NatWest Bank

NatWest Bank provides a full range of banking and insurance services to personal, business and commercial customers.

Services include; deposits, mortgages, credit cards, loans, life insurance services, pensions services, private banking services and advice regarding employment law, taxes, and health and safety to businesses.

Personal and Business Banking franchise

Services to businesses (generally up to £2 million turnover), individuals and HNWI customers in the UK, Ireland and Republic of Ireland.

Commercial Banking and Private Banking franchise

Services to commercial customers, mid-corporate customers and private banking HNWI in the UK.

NatWest Markets franchise

Services to corporate and institutional clients primarily in the UK and Western Europe, as well as those in the US and Asian multinationals. The segment's products include debt financing, risk management and trade services.

3. NatWest Markets Plc (formerly The Royal Bank of Scotland plc)

3.1 Introduction

NatWest Markets was founded in 1727 and has its registered office at 36 St. Andrew Square, Edinburgh EH2 2YB. NatWest Markets provides a wide range of banking and other financial services in the United Kingdom and worldwide. NatWest Markets is one of the banking subsidiaries of the RBS Group.

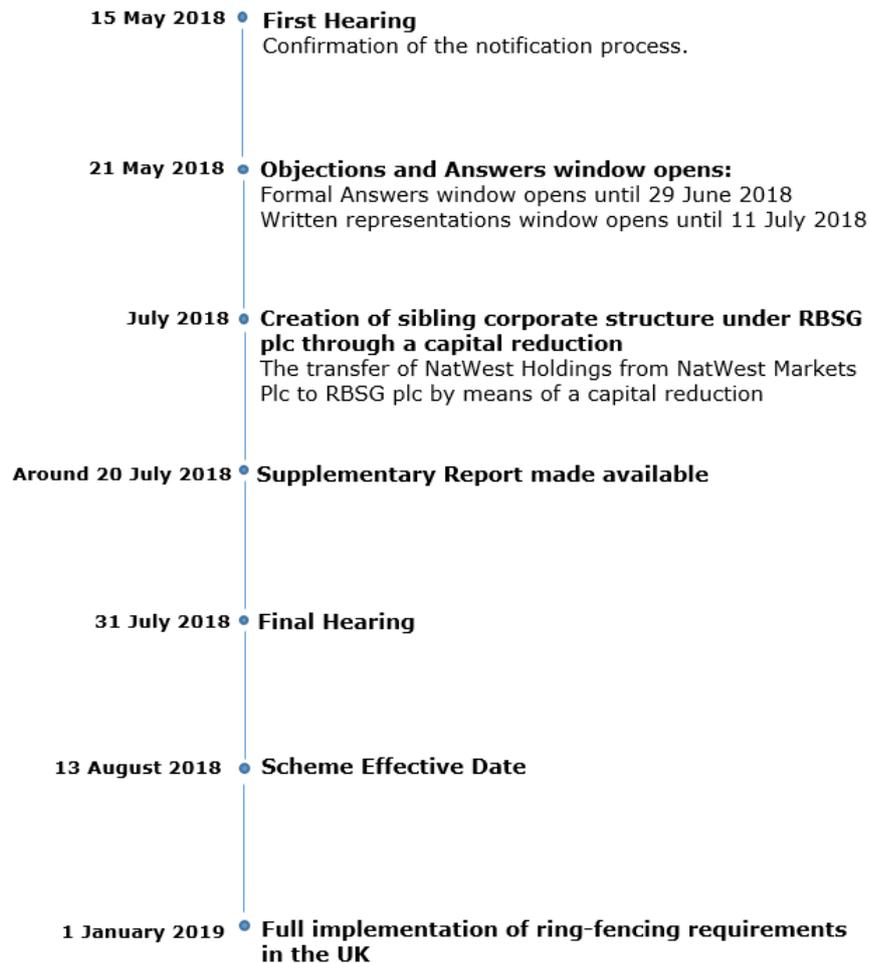
NatWest Markets is a wholly-owned subsidiary of RBSG plc.

3.2 Nature of business of NatWest Markets

NatWest Markets franchise

Serves UK and Western European corporate customers, and global financial institutions, supported by trading and distribution platforms in the UK, US and Singapore.

Appendix 3 - Ring-fencing timeline



Appendix 4 - Sources of information

This appendix sets out the categories of information that I have received, reviewed and relied upon in relation to the preparation of this Scheme Report. This includes various emails and documents received from management of the Companies and publicly available information. A list of the meetings held with RBS staff is set out separately.

Documents marked "*" in their final form are available upon request.

Documents marked "***" are legal advice provided by RBS legal advisers on which I have relied.

| |
|--|
| Scheme documents |
| *Scheme Document |
| *Summary Scheme Document |
| *Legal notices of the Scheme |
| Scheme planning, design and key features documents |
| Scheme timetable |
| *Court petition |
| Company background |
| Organisation charts: current and proposed for the RBS Group ring-fenced structure |
| Executive committee and board structures: current and proposed for ring-fenced structure |
| Executive committee: terms of reference |
| Senior Management Functions |
| Senior Management: statement of responsibilities |
| Annual Returns 2016: RBSG plc, NatWest Markets and NatWest Bank |
| Planned changes to company names: RBS plc to NatWest Markets plc and Adam & Company to RBS plc |
| Financial information |
| Audited financial statements for the year ended 31 December 2017: RBSG plc, NatWest Markets and NatWest Bank |
| Annual Reports 2017: RBSG plc, NatWest Markets and NatWest Bank |
| List of debt issuances June 2016: RBSG plc, NatWest Markets and NatWest Bank |
| Credit ratings: NatWest Markets and NatWest Bank |
| Financial analyses of effect of the Scheme assuming Effective Date of 13 August 2018: NatWest Markets and NatWest Bank |
| RBS Group 2018 Budget |
| Capital planning and planned capital injections and capital reductions: NatWest Markets and NatWest Bank |
| Analysis of reallocation of significant provisions |
| Intercompany receivables/payables between NatWest Markets and other companies of the RBS Group |
| Product information |
| Product and service listings |
| Description of product lifecycles |
| Legal due diligence on effect of the Scheme on product terms and conditions |
| Sample of product terms and conditions |

| |
|---|
| Customer information |
| Customer detriment analyses, including customer journeys and lifecycles |
| Analysis of potential loss of offset as a result of the Scheme |
| Sample customer files |
| Risk framework |
| Risk Appetite Framework |
| Risk Target Operating Model |
| Risk data management and credit risk reporting |
| Internal Capital Adequacy Assessment Process (ICAAP) 2017: RBSG plc, NatWest Markets, RFB Subgroup |
| Individual Liquidity Adequacy Assessment Process (ILAAP) 2018: RBSG plc, NatWest Markets, RFB Subgroup |
| Capital Support Deed |
| Intragroup liquidity support facility |
| Proposed changes to hedging arrangements |
| Tax |
| Corporation Tax returns 2016: NatWest Markets and NatWest Bank |
| Draft Corporation Tax computations 2016: NatWest Bank, NatWest Markets |
| RBS Group VAT returns: 2012-2015 |
| Analysis of tax effects of the Scheme |
| Analysis of tax effects of other ring-fencing transactions outside the Scheme |
| Correspondence with HMRC |
| Communications |
| Communications governance and strategy for the Scheme |
| Draft communication letters and booklets |
| Proposed communications channels: letters and booklets to be sent by post and email; RBS website and ring-fencing webpage; newspapers |
| Other |
| Shared Services Target Operating Model for ring-fenced structure |
| Draft Master Framework Agreement and Draft Template Intragroup Service Agreement: terms and conditions |
| Transfer pricing governance and policy for ring-fenced structure |
| IT Target Operating Models |
| IT and data change process |
| RBS Group Recovery Plan June 2017 |
| Operational Continuity in Resolution: Financial resilience |
| Creditor hierarchy analysis |
| Legal consideration of the effect of the Scheme on set-off arrangements |
| **Legal advice from Linklaters LLP on shared security arrangements |
| Correspondence with regulators |

Meetings held with RBS employees

| Meetings held with |
|---|
| <p>Ring-fencing Programme team:</p> <p>Executive Sponsor; Programme Director; Programme Planning Lead; Programme Government & Regulatory Strategy Lead; Programme Legal Lead; Programme Due Diligence Lead; Programme Finance Lead; Programme Target Operating Model Lead; Transformation Services Programme Lead</p> |
| <p>Business Franchise:</p> <p>Senior management from NWM Franchise</p> |
| <p>Tax:</p> <p>Tax Director, Transfer Pricing Director</p> |
| <p>HR Policy and Propositions:</p> <p>Pensions; Specialist Projects</p> |
| <p>Finance:</p> <p>Group CFO; Group Deputy CFO; Head of Capital Management; Treasury, COO of Finance for NatWest Markets; Financial Planning & Analysis</p> |
| <p>Risk:</p> <p>Board Risk Committee; Senior Change Risk Management and Head of Strategic Change; Head of Delivery, Risk & Conduct Transformation</p> |
| <p>Governance:</p> <p>Chief Governance Officer, Board Counsel and Company Secretary; Corporate Governance & Regulatory Affairs</p> |
| <p>Regulatory Design:</p> <p>Head of Regulatory Design</p> |
| <p>Internal Audit:</p> <p>Head of Audit - Regulatory Risk</p> |
| <p>IT & Systems:</p> <p>Technology Services</p> |
| <p>Communications:</p> <p>Communications & Marketing</p> |



This document is confidential and it is not to be copied or made available to any other party. Deloitte LLP does not accept any liability for use of or reliance on the contents of this document by any person save by the intended recipient(s) to the extent agreed in a Deloitte LLP engagement contract.

If this document contains details of an arrangement that could result in a tax or National Insurance saving, no such conditions of confidentiality apply to the details of that arrangement (for example, for the purpose of discussion with tax authorities).

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London, EC4A 3BZ, United Kingdom.

Deloitte LLP is the United Kingdom affiliate of Deloitte NWE LLP, a member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"). DTTL and each of its member firms are legally separate and independent entities. DTTL and Deloitte NWE LLP do not provide services to clients. Please see www.deloitte.com/about to learn more about our global network of member firms.

© 2018 Deloitte LLP. All rights reserved.