H1 Results 2016

WIRES Conference Call
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RBS

Ross McEwan, Chief Executive

Ewen Stevenson, Chief Finance Officer

Introduction

Good morning, ladies and gentlemen. Today's conference call will be hosted by Ross McEwan, CEO of RBS. Please go ahead, Ross.

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Ross McEwan, Chief Executive

Good morning, everyone, and thanks for joining Ewen and I for our first half results call. Let me just take a few minutes to give you a quick update before handing over to Ewen, who will take you through the numbers in a bit more detail, and then I'm very happy to take the questions.

We're at the midpoint of our five-year plan, and I think we're making good progress. We're clearly in phase two of our strategy, where our focus is on drawing a line under many of the legacy issues that have plagued this bank, and transforming the core business so we can deliver consistent, sustainable profits and results for our shareholders, and do great things for our customers.

We recorded a loss before tax of £274 million, and a bottom line loss of £2.045 billion, largely a result of the £1.315 million provision we have taken, which covers, amongst other things, the shareholder litigation arising from the 2008 rights issue, and a further provision for PPI following the FCA announcement this week.

This also includes the £1.2 billion dividend access share (DAS) payment we made to the government in Q1. But looking under the bonnet, you can see that our core business generates an adjusted operating profit of nearly £2 billion in the first half, and an average of £1 billion pounds for the last six quarters, showing the strength and resilience of the bank that we are fast becoming.

It's also worth taking a moment to reflect on how much we've changed as a bank over the last couple of years, which means we are much stronger, more resilient, and better, positioned to deal with any uncertainties and economic slow-down that we may face.

When I became the CEO in 2013, our common equity tier one ratio was 8.6 percent. Today it sits at 14.5%. Since then, we've taken out £2 billion pounds of costs, and we're on track to meet our £800 million pound target for this year.

We have a loan-to-deposit ratio of 92 percent, and we've reduced our risk-weighted assets by £184 billion, and we are on course to reduce from 38 countries to 13. This progress is important because it means we are well-positioned to support our customers through the challenges that an economic slow down poses for the country.

We have been the fastest growing bank in the UK, with net lending growing by £20 billion in the first half of the year, higher than any other bank. We're open for business, ready to lend responsibly, and ready to play our part in this new chapter for the country. We see opportunities too with strong positions in our key markets.

Now performance in the mortgage market continues to be strong, with mortgage lending up £3.4 billion in quarter two, despite a slow down in June as buyers awaited the referendum outcome, and we continue to take market share with a 12 percent share of new business compared to our stock share position of 8.6 percent.

As the biggest supporter of British businesses, we have now delivered our sixth consecutive quarter of net lending growth in the commercial business, remain committed to our entrepreneurs and to the smaller business market, with gross lending to SME's up 50 percent on the first half of last year, and we've recently launched a 1 billion pound fund for the small businesses.

All together, net lending is up 7 percent across our personal and commercial franchises, it surpasses our 4 percent target for the year. Our mobile app is one of the best in the market, and we were the first bank to be accredited by the Royal National Institute of Blind, something that we are very proud of.

Our Reward current account offering customers 3 percent cash back on household bills continues to gain momentum. We now have 815,000 customers with this account, compared with 202,000 at the beginning of 2015 – sorry, at the end of 2015, helping us to retain our most valuable customers.

You will have seen from our announcement on Williams & Glyn, that we are – have stood down the plan on separating the business. Williams & Glyn, unlike any other challenger bank in the market, needed to be stood up as a full service, retail, and commercial bank, with all the operational requirements that that entails.

The mix of the business also meant that it needed to scale up significantly to generate acceptable returns. Given the lower interest rate environment, it is clear that Williams & Glyn would now be unlikely to grow its balance sheet to the extent necessary to deliver returns above the cost of capital within the next five years.

We have been pursuing a trade sale route since the end of last year, and we feel the business remains attractive to the right owner, at the right scale, and we have had positive discussions with interested parties. We believe that a trade sale is likely to produce the best opportunity of delivering a divestment within the time frame.

No update would be complete without the usual cautioning on the remaining legacy issues that we still face and need to resolve, not least in relation to the main DoJ US. Mortgage backed securities case, and the FCA investigation into GRG. We have no update on these to date, but we have settled a smaller RMBS case, and putting these issues behind us remains a priority.

So, in summary, there is more work to be done, but we are making progress. The bank is fundamentally different to the one I took over. It's stronger, simpler, and fairer for our customers, and we have a strong market position in franchises we like, and we have great brands, and you'll hear a lot more about us talking about the brands in the future, and that will help us grow our business.

Thanks for joining us, and I'll hand over to Ewen for more detail on the numbers, and our progress against our 2016 goals, then we're happy to take questions. Ewen, over to you.

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Ewen Stevenson, Chief Finance Officer

Thanks, Ross. Three messages from me today, firstly, despite the attributable loss, a good set of results for the core business. Secondly, post the EU Referendum, while the credit outlook has weakened, we substantially de-risked our loan portfolios in recent years.

And thirdly, in this new environment, while tougher with lower interest rates and a weaker growth outlook, we're relatively well positioned to continue to capture profitable market share. On Q2, a good set of core results for us today, and progress against all of our financial targets.

Across our six franchises, on a combined basis, and for the second quarter in a row, and adjusted operating profit of just over 1 billion pounds, and a return on equity of 11 percent. As Ross highlighted, growth in the UK was again well above market.

UK personal and business banking continues to do very well. Another good volume – quarter of volume growth in mortgages. Post the vote, UK personal and business banking should be well-positioned. We expect to continue to capture market share, we remained very liquid, we've a loan-to-deposit ratio, and we're open to lend within our risk appetite.

Commercial banking had its sixth quarter of positive volume growth. We're confident that this franchise is the clear number one commercial and corporate bank in the UK is very well-positioned to continue to capture a profitable share.

Corporate and institutional banking had a much better quarter than Q1. Income was up 46 percent, and 18 percent on Q2 last year. And on the back of that, corporate and institutional banking made a small profit for the quarter.

With the outlook now for a tough income environment, we know we need to be relentless on costs. We think we're building a very credible track record of delivery on this. Over the last two-and-a-half years, we've taken run rate costs now – down by some 2.5 billion pounds, including a further 404 million pounds in the last six months.

But we recognize we need to continue to target this sort of reduction for several more years, until we get our overall cost structure back to acceptable and competitive levels.

Another area that I think we've done a very credible job on is reducing our legacy exposures. RWA's for our legacy portfolios are now down to only 55 billion pounds, that's just 23 percent of our total RWA's from around half 18 months ago. And in achieving this accelerated run-off, we've also significantly de-risked the bank.

On our medium term targets, a 12 plus percent return on equity, and a sub 50 percent cost income ratio. It's too early to give you a revised guidance, but we recognize that reaching these targets by 2019 is now uncertain, and is likely to be more challenging.

In recent weeks, UK commercial real estate exposure has received a lot of attention from the investment community. In short, we don't feel overly exposed. Given our history, we've had a cautious new business risk appetite in this sector, and we've dramatically shrunk our legacy exposure.

We're the largest commercial bank in the country, so you would expect us to be one of the largest commercial real estate lenders. Our total UK exposure is now down to 25 billion pounds, and our average loan-to-value is 53 percent.

We're also not overly exposed in the residential mortgage sector. Overall mortgages are only 44 percent of total net customer loans, and the average loan-to-value for the mortgage book is only 59 percent.

So to summarize, we've got a strong and growing core bank that delivered again in Q2, over 1 billion pounds of adjusted operating profit, and 11 percent return on equity. The EU Referendum does create new uncertainty, but we're robustly positioned for this across personal and business banking, and commercial banking.

We expect this interest rate and macro environment to generate lower, but still attractive returns, and for corporate and institutional banking with higher likely FX and interest rate volatility, we should see an income upside opportunity. So with that, I'll pass back to Ross to host some Q&A.

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Ross McEwan, Chief Executive
Thanks for that, Ewen. Gary, can we just open the lines up now for questions, please?

Operator
Thank you, Ross. Ladies and gentlemen, if you would like to ask a question, please press the star key followed by the digit 1 on your telephone keypad. We will pause for a moment to give everyone an opportunity to signal for questions. Your first question comes from Andrew McCaskill from Reuters. Please ask your question.

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Andrew MacCaskill, Reuters
Hi, good morning. I just wanted to know why it's taken you so long to change strategy on Williams & Glyn?

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Ross McEwan, Chief Executive
Well look, if you recall at the end of last year, I think it was November or December of last year, we did raise the issue of a trade sale alongside the IPO, and it was at that time we started to see the real impact of interest rates lower for longer, and as you've just seen yesterday, they're going to be lower for longer and longer I suspect. So our view was end of last year that we should look at all options associated with it, and that's – and that's what we've done.

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Ewen Stevenson, Chief Finance Officer
Yes, I think, Andrew, when we – the actual IT separation process was actually going very well. We were through standing up more than 90 percent of the systems. I think what's sort of fundamentally changed over the last few months in particular, it accelerated after the EU Referendum, was that it was the interest rate outlook.

As we sort of signaled in our results today, we do think for us it is going to be a more challenging environment, with structurally lower profitability for the big banks, and for the challenger banks they will be more challenged on the back of it.

And we did want to create a viable stand-alone Williams & Glyn. We think the best way of creating a viable Williams & Glyn today is to do a trade sale.

Andrew MacCaskill, Reuters

I mean, if I can just following up there, I mean you just spent an enormous amount of money trying to pull off what you call the most complex restructuring in banking, and it hasn't worked. So is anyone going to lose their job over this strategy, and if not, why not?

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Ross McEwan, Chief Executive

Well first off, we do have a strategy of extracting it out, and as I said, we've taken out 90 something percent of all the systems, and put them into a production environment, which is exactly what we said we'd do. So you know, you can't criticise our technology people for doing what we've asked them to do.

The issue that Ewen raised, and quite right, we saw this as we went into the end of last year, interest rates does impact a bank of this nature dramatically. It takes its return on equity down over the next five years quite considerably, because banks are hit with the (?) contraction.

So I'm, you know, I'm a bit surprised that we immediately go to actually punishing our people for an environmental issue well out of their control. So we're doing what we said we'd do, we have a commitment to actually get this – get more competition in the marketplace through SME, and we'd look – said last year, we'd look at every opportunity and that's exactly what we've done. We have had interest in it, and we pursued it.

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Operator

Thank you. Your next question comes from Max Colchester from the Wall Street Journal. Please ask your question.

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Ross McEwan, Chief Executive

Hi, Max.

Max Colchester, Wall Street Journal

Hi, Ross and Ewen. Does this mean that future dividends now are really kind of over the horizon given this low rate environment, and that the sort of persistent and long-lasting restructuring and litigation costs?

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Ross McEwan, Chief Executive

Well we've always said that there are a number of things that we had to get out of the way before we'd be in position to provide dividends. Williams & Glyn is one of them, Department of Justice another, and getting through a stress testing.

You know, we've seen that the Williams & Glyn is taking us longer; we've said that last year. And DoJ is out of my control time-wise, so you know, a lot of (inaudible) to that. But you know, we also clearly said at the first quarter results that dividends were not likely to be this year, they're more likely to be, you know, first time possibly would be 2018 at the earliest.

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Ewen Stevenson, Chief Finance Officer

I think also, Max, when you look at the results today, it's the second quarter in a row of more than 1 billion pounds of pre-tax profit for the core business. When we get through the legacy issues, that becomes a very attractive cash flow, able to sustain attractive dividend payout ratios. So that's what we're working towards.

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Max Colchester, Wall Street Journal

Yes, and you've obviously sort of softened – or seem to have softened your guidance a bit following Brexit and the interest rate cut. Can you give us a bit more detail as to how you see things playing out?

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Ross McEwan, Chief Executive

Well we've still got a lot of work to do on future budgeting and plans for the next three to five years, so all we've said that given there will be lower interest rates for a lot longer now, we do have to start factoring that in and so does the market, and I think every bank that's come out in the last two weeks has said exactly the same. We're all affected the same way.

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Max Colchester, Wall Street Journal
So when will we get clarity on that do you think?

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Ross McEwan, Chief Executive
Well we've got a process that we'll run through until the end of this year, and we'll have indications on how we see things probably first half of next year.

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Operator
Thank you. Your next question comes from Richard Partington from Bloomberg. Please ask your question.

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Ross McEwan, Chief Executive
Hi, Richard.

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Richard Partington, Bloomberg
Hi there. Good morning, both. Firstly, just wanted to ask on the litigation charge that you took in relation to the shareholder lawsuits, looking for a bit more detail on how much that is, and why you've had to take it, and what the likelihood of settlement is with that group of shareholders.

And then secondly, on Williams & Glyn, how progressed are discussions to sell the bank to a trade buyer?

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Ross McEwan, Chief Executive
Let's take the first one first. We haven't disclosed the exact amount. We have we did enter into mediation, which is what you'd expect, before heading into a court case, which is set for the beginning of next year. We did go into mediation

with good intent. Unfortunately didn't get a settlement, but having made – put some money on the table, you know, we felt we should make a provision for that.

On the second piece around Williams & Glyn, we are talking to a number of players. I won't give any timetable around that, because these things can take a lot longer than people anticipate, but we thought we should tell the market that where we are at.

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Ewen Stevenson, Chief Finance Officer
Richard, you know, it's likely to be months rather than weeks I think.

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Operator
Thank you. Your next question comes from Emma Dunkley from the Financial Times. Please ask your question.

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Ross McEwan, Chief Executive
Hi, Emma.

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Emma Dunkley, Financial Times
Oh hi. I was just wondering what happens to all the people that you've moved onto a separate payroll for Williams & Glyn, and also I mean what do you say to the sort of 1.4 billion you spent on this? I mean what happens? That just now goes to waste.

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Ross McEwan, Chief Executive
Well first off, the staff that were moved across, they will be the people – if we do sell the business, will be the people that move across the business, so that move hasn't been wasted in any shape. It's about 5,500 people that work inside Williams & Glyn, and that's the group of people that look after those customers. So you know, that move was probably a good one.

There is always a cost with any of these exercises, Emma. This comes back from a state aid requirement that we have along with selling of Citizens, along with selling of Simpra, Direct Line Group and WorldPay. You know, these are part of the costs that we have to bear to actually live with those obligations under the state aid, and those costs have been expensed on the way through.

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Operator

Thank you. Your next question comes from Jill Treanor from the Guardian. Please ask your question.

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Ross McEwan, Chief Executive

Hi, Jill.

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Jill Treanor, The Guardian

Hi. Good morning, both. I just wanted to ask you, the – Mark Carney yesterday talked very clearly about the fact you had no excuses for passing on rate cuts to your borrowers. I wondered can you talk to us about what your intentions are about passing on those rate cuts, and how are you going to handle savers?

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Ross McEwan, Chief Executive

Well the unfortunate thing about low interest rates, Jill, as you would know, and interest rates coming lower, it just does hit the savers every time, because it's their – those savings that become less – of less value.

And there's a lot of money in circulation in our bank, very secure, we've got a 92 percent loan-to-deposit ratio, so we actually have more deposits than we actually do have lending on the books. So it is a tough time for the savers and investors at this point in time.

A lot of our lending on the other side of the book is on index rated, so as the index has moved down 0.25 that will be automatically moved through. A number of third contracts have a 60 or 90 day period where we have to notify customers, so you know, we've started that process.

You see a lot of our mortgage book, 88 to 90 percent of it is either on index linked that I've just talked about, or fixed rate, so there's only a small portion on the standard variable there. We've seen a big move of customers move towards index rates or to fixed rates, because some of those rates are as low as 1.67, I think percent.

We have maintained one of the lowest standard variable rates in the market for the last six years, and I do note that those who have moved quite quickly have still not come down to that rate, but we will be reviewing all of our rates over the next – over the next week, both savers and also for lenders.

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Jill Treanor, The Guardian
It sounds as if you don't think you're going to move that SVR, and you're saying that it's still one of the lowest out there.

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Ross McEwan, Chief Executive
Oh it is one of the lowest, and it has been for six years, Jill, if you look at the stats, and we just have to review those in the rounds with every other rate that we've got, but we've got few customers left on a standard variable rate, they're all on either fixed or on an index linked.

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Operator
Thank you. Your next question comes from Nick Goodway, from the Evening Standard. Please ask your question.

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Nick Goodway, Evening Standard
Good morning, Ross and Ewen. Can you – can you tell me, do you understand the term finance scheme, and are you expecting to use it, and how?

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Ross McEwan, Chief Executive

We've only got the detail of it yesterday, Nick, so still in sort of digest mode. I mean the scheme is there to make sure that there are no concerns about having money in the system to lend, and we absolutely understand the importance of that.

As I said, we're running with a 92 percent loan-to-deposit ratio. In the first six months of this year, we put into the marketplace £20 billion of net lending to businesses and to households. We were the largest lender in the marketplace in the first six months of this year.

So if there's a good, prudent loan, you know, we'll be available to lend, and we'll have a look at the scheme. I think it's a good initiative by the Bank of England, because they just want to make sure that there is money in the system if people do have a good, valid borrowing purpose. I've yet to go through the detail of it.

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Operator

Thank you. Your next question comes from Tim Wallace from the Telegraph. Please ask your question.

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Ross McEwan, Chief Executive

Hi, Tim.

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Ewen Stevenson, Chief Finance Officer

Hi, Tim.

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Tim Wallace, Daily Telegraph

Hello, and good morning. The dividend seems to be disappearing over the horizon again, which our clients think is obviously absolutely abysmal at the moment. What do you say to shareholders who are looking for some kind of return from their holdings here? And also to the government, since it obviously doesn't look like they're going to have their money back any time soon either.

Ross McEwan, Chief Executive

Well I think you've got to look in the round here of bank stocks are well and truly down, and that's because interest rates being lower for longer, which have been signaled over the last six months, it clearly impacted earnings of banks.

We just – we are in that sector, we're clearly a bank, and it does impact our earnings. So I think that's what's pulled bank stocks down. You know, the uncertainty around Brexit hasn't helped the UK domiciled banks, which is you know, what we truly are one now.

But you know, our job is just to make sure that we get this bank into great shape. As Ewen said, our core earnings on this business for our six businesses that we're concentrating on, you know, 11 percent return on equity, and 1 billion pounds of quarter pre-tax.

So our job is just to get this thing back in place, get the assets that we don't want, off the book, do as much of the restructuring as we possibly can, and also it's the litigation that's holding – and conduct issues that are holding this bank back.

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Ewen Stevenson, Chief Finance Officer

I don't think there's anything in today's results Tim that changes our view on timing on distributions.

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Tim Wallace, Daily Telegraph

Last year you said that you should be back to some sort of normality by 2019. Is that still the picture do you think, or is Brexit and so on delayed that further?

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Ross McEwan, Chief Executive

Well look, we are examining, you know, what the moves for an even lower interest rate period is going to be on the bank. As we said, it does hurt our earnings. We have to adjust to make sure that we are still heading towards those targets.

We are saying today that it could be more difficult, and it may take us another period of time, but we haven't gone through all those numbers yet, and we'll do so at the beginning of next year.

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Ewen Stevenson, Chief Finance Officer
But Tim, the thing that's sort of important to recognize, we are a normal bank today. Within our bank, we've got six franchises that are doing very, very well. Over the last six quarters I think we've generated 1 billion pounds per quarter on average, pre-tax, out of those businesses.

The only thing holding us back from normality, so to speak, is the speed at which we work through the legacy issues. Actually today, while we did take sizable conduct provisions, that's a good sign of us continuing to make progress, and cleaning up the past.

On the capital resolution, we've taken out another 5 billion of RWA's out of capital resolution in the last quarter. We used to have half of our capital tied up in legacy 18 months ago. We're now down to less than a quarter. We also paid back the dividend access share in the first quarter of this year. So we do think we're making good progress, and on plan to get back to just being able to talk about our core business.

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Ross McEwan, Chief Executive
I think the other thing is we've been very clear about the issues we're solving for, the 2008 rights issues being there, the dividend access share was there, the Department of Justice (RMBS) issues we've always been there, you know, the pension issues that we put 4.2 billion into the fund at the start of the year were there, PPI's been there.

So I think we've been very clear about what we're solving for, but at the same time, building a very good bank here in the UK, and that certainly showed through in our first six months with our lending growth, which has been the, I think the best of any bank in the UK, certainly the big banks. And that was a complaint against us quite rightly three years ago, that we weren't lending into the economy. Well we are certainly doing – playing our part.

Gary, any other questions?

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Operator

We do. Your next question comes from James Burton, from the Daily Mail. Please ask your question.

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Ross McEwan, Chief Executive

Hi, James.

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James Burton, Daily Mail

Oh, good morning, both. So I just had a couple of questions. First of all, Mark Carney obviously yesterday was very explicit when he said that there was no excuse for banks not to pass the interest rate onto customers.

Given that you're obviously still mulling over what you do from here, and given that you seem to have opened the door for possibly charging business customers for their deposits, do you think you're potentially opening the door to quite sort of serious criticism here if you – if you don't pass those cuts on?

And my second question was about the ECB stress tests. You obviously came off the worst of the large UK lenders in that, I mean does that give you any cause for concern?

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Ross McEwan, Chief Executive

Well I'll start with the last one first. We didn't come off the worst on the ECB. I think we started from one of the best positions of capital at 14.5 percent, or 14.6 percent common equity tier one. After stress, which is mainly related, and pretty much related to our conduct and litigation issues that get deducted off, including the DoJ, RMBS, brings us down to just over the 8 percent.

That was by no means a bad result, or the worst bank in the marketplace. So I think the interpretation of that needs to be tidied up. Just because we start from a very high position, we're there because we do have some issues that we need to resolve, we're very clear about those. So I think it's worth having a chat to our people about the stress testing, and what it actually means.

On the second one, yes, clearly Mark Carney did put a lot of money into the system yesterday, which I think is very good. He also made it very clear that, you know, they'll do whatever they need to do to keep the economy moving, which in itself is good, because we need employment in the UK to stay high, and unemployment to stay very low. That's important.

I think those moves yesterday said there's money to borrow, and we'll put that into the system. As I said, we are over 92 percent cost to income rate. He also said yesterday I think which is quite important that there wouldn't be a negative interest rate environment.

Now we had to make some changes to contracts recently for our business customers, which gave, if things did go negative, is the fact that we could then actually charge a negative interest rate. We have no intention to do so, it's not in our plans, but I think prudently from a banking perspective, we also needed to make sure that our contracts aligned, as do most other banks, already have that requirement inside their contracts.

The other thing about their contract also brought down the rates on many of our business customers, both the interest – the actually charging basis down for them. So I think in there, people picked up the change in the terms, but they didn't pick up the fact that it actually became cheaper for a lot of business bank customers to actually operate with us.

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Operator
Thank you, Ross. I'll now hand the call back to you for closing comments.

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Ross McEwan, Chief Executive
Thanks very much for joining us. I know we'll have conversations through the day with many of you, and at lunchtime. Look, we're making very good

progress working through the remaining legacy issues, and we've seen some of those come through in our results today.

We are transforming this bank for customers. We've generated operating profit of 1 billion pounds in the core bank for each of the last six quarters. So I think, you know, the bank is showing very quickly that this is a very good, solid bank underneath things.

We are much stronger, more resilient, and well-positioned to deliver value for shareholders, and support our customers through what are becoming I think challenging times, and any slow down in the economy will show us that.

We've been the fastest growing large bank in the U.K., with net lending of £20 billion in the first half of this year, higher than any other bank. So we are playing out our part. We're open for business, ready to lend responsibly. Remember, that was an important word, responsibly, and we're ready to play our part in this new chapter of the country.

On Williams & Glyn, we have made some announcements there. We do – their business does need scale in a very low interest rate environment, and we are picking up what we see at the end of last year, which was we would look at trade sale as well as the IPO.

Thanks very much for joining us on the call. All the best, and for all of you who are going on holiday, enjoy that as well. Cheers.

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Operator
Ladies and gentlemen, that will conclude today's call. Thank you for your participation. You may now disconnect.

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