ROYAL BANK OF SCOTLAND GROUP PLC
Form 20-F
April 24, 2007

As filed with the Securities and Exchange Commission on April 24, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

(Mark One)

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2006

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

o **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of event requiring this shell company report __________
For the transition period from __________ to __________

Commission file number 001-10306

THE ROYAL BANK OF SCOTLAND GROUP plc

(Exact name of Registrant as specified in its charter)

United Kingdom
(Jurisdiction of incorporation or organization)

RBS Gogarburn, PO Box 1000, Edinburgh EH12 1HQ
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on wh

American Depositary Shares Series D**, E*, F, G*, H, I**, K*, L, M, N, P, Q and R each representing one Non-Cumulative Dollar Preference Share, Series D, E, F, G, H, I, K, L, M, N, P, Q and R, respectively	New York Stock Exchange
Dollar Perpetual Regulatory tier one securities, Series 1	New York Stock Exchange

* Redeemed on January 16, 2007
** Redeemed on March 6, 2006

Securities registered or to be registered pursuant to Section 12(g) of the Act:
None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:
None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of December 31, 2006, the close of the period covered by the annual report:

Ordinary shares of 25 pence each	3,152,844,335	Non-cumulative dollar preference shares, Series E to H and K to R	240,000,00
Non-voting Deferred Shares	2,660,556,304	Non-cumulative convertible dollar preference shares, Series 1	1,000,00
11% cumulative preference shares	500,000	Non-cumulative euro preference shares, Series 1 and 2	2,500,00
5½% cumulative preference shares	400,000	Non-cumulative convertible sterling preference shares, Series 1	200,00

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act

Yes x No o

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes o No x

Note – checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x   Accelerated filer o   Non-accelerated filer o

Indicate by check mark which financial statement item the registrant has elected to follow.

o Item 17 x Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes o No o

SEC Form 20-F cross reference guide

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Operating and financial review

Presentation of information

In the Report and Accounts, and unless specified otherwise, the term “company” means The Royal Bank of Scotland Group plc, “RBS” or the “Group” means the company and its subsidiary undertakings, “the Royal Bank” means The Royal Bank of Scotland plc and “NatWest” means National Westminster Bank Plc.

The company publishes its financial statements in pounds sterling (“£” or “sterling”). The abbreviations “£m” and “£bn” represent millions and thousands of millions of pounds sterling, respectively, and references to “pence” represent pence in the United Kingdom (“UK”). Reference to “dollars” or “$” are to United States of America (“US”) dollars. The abbreviations “$m” and “$bn” represent millions and thousands of millions of dollars, respectively, and references to “cents” represent cents in the US. The abbreviation “€” represents the “euro”, the European single currency and the abbreviations “€m” and “€bn” represent millions and thousands of millions of euros, respectively.

Certain information in this report is presented separately for domestic and foreign activities. Domestic activities primarily consist of the UK domestic transactions of the Group. Foreign activities comprise the Group’s transactions conducted through those offices in the UK specifically organised to service international banking transactions and transactions conducted through offices outside the UK.

The geographic analysis in the average balance sheet and interest rates, changes in net interest income and average interest rates, yields, spreads and margins in this report have been compiled on the basis of location of office – UK and overseas. Management believes that this presentation provides more useful information on the Group’s yields, spreads and margins of the Group’s activities than would be provided by presentation on the basis of the domestic and foreign activities analysis used elsewhere in this report as it more closely reflects the basis on which the Group is managed. “UK” in this context includes domestic transactions and transactions conducted through the offices in the UK which service international banking transactions.

The results, assets and liabilities of individual business units are classified as trading or non-trading based on their predominant activity. Although this method may result in some non-trading activity being classified as trading, and vice versa, the Group believes that any resulting misclassification is not material.

International Financial Reporting Standards

As required by the Companies Act 1985 and Article 4 of the European Union IAS Regulation, the consolidated financial statements of the Group are prepared in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board (“IASB”) and interpretations issued by the International Financial Reporting Interpretations Committee of the IASB (together “IFRS”) as adopted by the European Union. On implementation of IFRS on 1 January 2005, the Group took advantage of the option in IFRS 1 “First-time Adoption of International Financial Reporting Standards” to implement IAS 39 “Financial Instruments: Recognition and Measurement”, IAS 32 “Financial Instruments: Disclosure and Presentation” and IFRS 4 “Insurance Contracts” from 1 January 2005 without restating its 2004 income statement and balance sheet. The date of transition to IFRS for the Group and the company and the date of their opening IFRS balance sheets was 1 January 2004.

The Group’s published 2004 financial statements were prepared in accordance with then current UK generally accepted accounting principles (“UK GAAP” or “previous GAAP”) comprising standards issued by the UK Accounting Standards Board, pronouncements of the Urgent Issues Task Force, relevant Statements of Recommended Accounting Practice and provisions of the Companies Act 1985. The Group also presents information under generally accepted accounting principles in the US (“US GAAP”).

Forward-looking statements

Certain sections in this document contain forward-looking statements as that term is defined in the United States Private Securities Litigation Reform Act of 1995, such as statements that include the words expect, estimate, project, anticipate, believes, should, intend, plan, probability, risk, Value-at-Risk (VaR), target, go
objective, will, endeavour, outlook, optimistic, prospects and similar expressions.

In particular, this document includes forward-looking statements relating, but not limited, to the Groups potential exposures to various types of market risks, such as interest rate risk, foreign exchange rate risk and commodity and equity price risk. Such statements are subject to risks and uncertainties. For example, certain of the market risk disclosures are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market risk disclosures are only estimates and, as a result, actual future gains and losses could differ materially from those that have been estimated.

Other factors that could cause actual results to differ materially from those estimated by the forward-looking statements contained in this document include, but are not limited to: general economic conditions in the UK and in other countries in which the Group has significant business activities or investments, including the United States; the monetary and interest rate policies of the Bank of England, the Board of Governors of the Federal Reserve System and other G-7 central banks; inflation; deflation; unanticipated turbulence in interest rates, foreign currency exchange rates, commodity prices and equity prices; changes in UK and foreign laws, regulations and taxes; changes in competition and pricing environments; natural and other disasters; the inability to hedge certain risks economically; the adequacy of loss reserves; acquisitions or restructurings; technological changes; changes in consumer spending and saving habits; and the success of the Group in managing the risks involved in the foregoing.

The forward-looking statements contained in this document speak only as of the date of this report, and the Group does not undertake to update any forward-looking statement to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

For a further discussion of certain risks faced by the Group, see Risk factors on page 6.

Operating and financial review

Description of business

Introduction

The Royal Bank of Scotland Group plc is the holding company of one of the worlds largest banking and financial services groups, with a market capitalisation of £62.8 billion at the end of 2006. Headquartered in Edinburgh, the Group operates in the UK, US and internationally through its two principal subsidiaries, the Royal Bank and NatWest. Both the Royal Bank and NatWest are major UK clearing banks whose origins go back over 275 years. In the US, the Groups subsidiary Citizens is ranked the eighth largest commercial banking organisation by deposits. The Group has a large and diversified customer base and provides a wide range of products and services to personal, commercial and large corporate and institutional customers.

The Group had total assets of £871.4 billion and shareholders equity of £40.2 billion at 31 December 2006. It is strongly capitalised with a total capital ratio of 11.7% and tier 1 capital ratio of 7.5% as at 31 December 2006.

Organisational structure and business overview

The Groups activities are organised in the following business divisions: Corporate Markets (comprising Global Banking & Markets and UK Corporate Banking), Retail Markets (comprising Retail and Wealth Management), Ulster Bank, Citizens, RBS Insurance and Manufacturing. A description of each of the divisions is given below.

Corporate Markets is focused on the provision of banking, investment and risk management services to medium and large businesses and financial institutions in the UK and around the world. Corporate Banking and Financial Markets was renamed Corporate Markets on 1 January 2006 when we reorganised our activities into two businesses, Global Banking & Markets and UK Corporate Banking, in order to enhance the service provided to these two customer segments.

Global Banking & Markets (GBM) is a leading banking partner to major corporations and financial institutions around the world, providing an extensive range of debt financing, risk management and investment services to its customers. GBM has a wide range of clients across its chosen markets. It has relationships with an overwhelming majority of the largest UK, European and US corporations and institutions. GBMs principal activity in the US is conducted through RBS Greenwich Capital.

UK Corporate Banking is the largest provider of banking, finance and risk management services to UK corporate customers. Through its network of relationship managers across the country it distributes the full range of Corporate Markets products and services to companies.

Retail Markets was established in June 2005 to lead coordination and delivery of our multi-brand retail strategy across our product range and comprises Retail (including our direct channels businesses) and Wealth Management.

Retail comprises both the Royal Bank and NatWest retail brands, and a number of direct providers offering a full range of banking products and related financial services to the personal, premium and small business markets across several distribution channels.

In core retail banking, Retail offers a comprehensive product range across the personal and small business market: money transmission, savings, loans, mortgages and insurance. Customer choice and product flexibility are central to the retail banking proposition and customers are able to access services through a full range of channels, including the largest network of branches and ATMs in the UK, the internet and the telephone.

Retail also includes the Groups non-branch based retail businesses that issue a comprehensive range of credit and charge cards to personal and corporate customers and provides card processing services for retail businesses. Retail is the leading merchant acquirer in Europe and ranks fourth globally.

It also includes Tesco Personal Finance, The One account, First Active UK, Direct Line Financial Services and Lombard Direct, all of which offer products to customers through direct channels principally in the UK. In continental Europe, Retail offers a similar range of products through the RBS and Comfort Card brands.

Wealth Management provides private banking and investment services to its clients through a number of leading UK and overseas private banking subsidiaries and offshore banking businesses. Coutts is one of the world's leading international wealth managers with offices in Switzerland, Dubai, Monaco, Hong Kong and Singapore, as well as its premier position in the UK. Adam & Company is the major private bank in Scotland. The offshore banking businesses The Royal Bank of Scotland International and NatWest Offshore deliver retail banking services to local and expatriate customers, principally in the Channel Islands, the Isle of Man and Gibraltar.

Ulster Bank Group brings together the Ulster Bank and First Active businesses to provide a comprehensive range of products and services to retail and corporate customers in the island of Ireland.

Ulster Bank Retail Markets serves personal customers through both the Ulster Bank and First Active brands. Ulster Bank provides branch banking and direct banking services throughout the island of Ireland. First Active, through its branch network, serves personal customers in the Republic of Ireland with its separately branded product offerings, including mortgages and savings.

Ulster Bank Corporate Markets caters for the banking needs of business and corporate customers, including treasury and money market activities, asset finance, e-banking, wealth management and international services. Business and corporate banking services are provided via centrally-based relationship management teams and dedicated Business Centres located across both Northern Ireland and the Republic of Ireland.

Citizens is the second largest commercial banking organisation in New England and the eighth largest commercial banking organisation in the US measured by deposits. Citizens provides retail and corporate banking services under the Citizens brand in Connecticut, Delaware, Massachusetts, New Hampshire, New Jersey, New York state, Pennsylvania, Rhode Island and Vermont and the Charter One brand in Illinois, Indiana, Michigan and Ohio. Through its branch network Citizens provides a full range of retail and corporate banking services, including personal banking, residential mortgages and cash management.

In addition, Citizens engages in a wide variety of commercial lending, consumer lending, commercial and consumer deposit products, merchant credit card services, trust services and retail investment services. Citizens includes RBS National Bank, our US credit card business, RBS Lynk, our merchant acquiring business, and Kroger Personal Finance, our credit card joint venture with the second largest US supermarket group.

RBS Insurance is the second largest general insurer in the UK, by gross written premiums. It sells and underwrites retail, SME and wholesale insurance over the telephone and internet, as well as through brokers and partnerships. The Retail Divisions of Direct Line, Churchill and Privilege sell general insurance products direct to the customer. Through its International Division, RBS Insurance sells motor insurance in Spain, Germany and Italy. The Intermediary and Broker Division sells general insurance products through its network of independent brokers.

Manufacturing supports the customer-facing businesses and provides operational, technology and customer support in telephony, account management, lending and money transmission, global purchasing, property and other services.

Manufacturing drives optimum efficiencies and supports income growth across multiple brands and channels by using a single, scalable platform and common processes wherever possible. It also leverages the Group's purchasing power and has become the centre of excellence for managing large-scale and complex change.

The expenditure incurred by Manufacturing relates to costs principally in respect of the Group's banking and insurance operations in the UK and Ireland. These costs reflect activities that are shared between the various customer-facing divisions and consequently cannot be directly attributed to individual divisions. Instead, the Group monitors and controls each of its customer-facing divisions on revenue generation and direct costs whilst in Manufacturing such control is exercised through appropriate efficiency measures and targets. For financial reporting purposes the Manufacturing costs have been allocated to the relevant customer-facing divisions on a basis management considers to be reasonable.

The Centre comprises group and corporate functions, such as capital raising, finance, risk management, legal, communications and human resources. The Centre manages the Group's capital requirements and Group-wide regulatory projects and provides services to the operating divisions.

Recent development

In response to press speculation on a potential bid for the Dutch bank, ABN AMRO, the Group, Fortis SA/NV and Santander Central Hispano S.A. (collectively, the Banks) confirmed that they had submitted a joint letter dated 12 April 2007 to the Chairmen of the Supervisory and Managing boards of ABN AMRO to express the Banks interest in putting forward a proposal for the acquisition of ABN AMRO and their preference to work with ABN AMRO to make an offer to ABN AMRO shareholders. The Banks requested access to the same due diligence information given to Barclays.

In response to this letter, a meeting between the Banks and ABN AMRO was arranged for 23 April 2007 when the Banks would clarify their intentions and interests and allow their proposals to be considered by the Board of ABN AMRO alongside any proposals from Barclays.

However, on 23 April 2007 ABN AMRO and Barclays announced that they had reached agreement on the terms of a merger, and ABN AMRO announced that it had decided to sell LaSalle Bank to Bank of America. In view of these developments, the Banks requested further information to understand the circumstances under which the sale of LaSalle Bank can be terminated. Accordingly, the Banks did not consider it appropriate to meet with ABN AMRO as arranged and are currently considering their position.

Competition

The Group faces intense competition in all the markets it serves. In the UK, the Group's principal competitors are the other UK retail and commercial banks, building societies and the other major international banks represented in London.

Competition for corporate and institutional customers in the UK is from UK banks and from large foreign financial institutions who are also active and offer combined investment and commercial banking capabilities. In asset finance, the Group competes with banks and specialised asset finance providers, both captive and non-captive.

In the small business banking market, the Group competes with other UK clearing banks, specialist finance providers and building societies.

In the personal banking segment the Group competes with UK banks and building societies, major retailers, life assurance companies and internet-only players. In the mortgage market the Group competes with UK banks and building societies. National Westminster Life Assurance Limited and Royal Scottish Assurance compete with Independent Financial Advisors and life assurance companies.

In the UK credit card market large retailers and specialist card issuers, including major US operators, are active in addition to the UK banks. Competitive activity is across a number of dimensions including introductory and longer term pricing, loyalty and reward schemes, and packaged benefits. In addition to physical distribution channels, providers compete through direct marketing activity and the internet. The market remains very competitive, both between issuers and with other payment methods.

In Wealth Management, The Royal Bank of Scotland International competes with other UK and international banks to offer offshore banking services. Coutts and Adam & Company compete as private banks with UK clearing and private banks, and with international private banks. Competition in wealth management activities has intensified as banks have increased their focus on competing for affluent and high net worth customers.

RBS Insurance competes in personal lines insurance and, to a limited extent, in commercial insurance. There is strong competition from a range of insurance companies which now operate telephone and internet direct sales businesses. Competition in the UK motor market remains particularly intense. RBS Insurance also competes with local insurance companies in the direct motor insurance markets in Spain, Italy and Germany.

In Ireland, Ulster Bank and First Active compete in retail and commercial banking with the major Irish banks and building societies, and with other UK and international banks and building societies active in the market. Competition is intensifying as UK, Irish and other European institutions seek to expand their businesses.

In the United States, where competition is intense, Citizens competes in the New England, Mid-Atlantic and Midstates retail and mid-corporate banking markets with local and regional banks and other financial institutions. The Group also competes in the US in large corporate lending and specialised finance markets, and in fixed-income trading and sales. Competition is principally with the large US commercial and investment banks and international banks active in the US.

In other international markets, principally in continental Europe, the Group faces competition from the leading domestic and international institutions active in the relevant national markets.

Operating and financial review continued

Risk factors

Set out below are certain risk factors which could affect the Group's future results and cause them to be materially different from expected results. The Group's results are also affected by competition and other factors. The factors discussed in this report should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties.

The Group's business and earnings are affected by general business and geopolitical conditions

The performance of the Group is influenced by economic conditions particularly in the UK, US and Europe. Downturns in these economies could result in a general reduction in business activity and a consequent loss of income for the Group. It could also cause a higher incidence of credit losses and losses in the Group's trading portfolios. Geopolitical conditions can also affect the Groups earnings. Terrorist acts and threats and the response of governments in the UK, US and elsewhere to them could affect the level of economic activity. The Group's business is also exposed to the risk of business interruption and economic slowdown following the outbreak of a pandemic.

The financial performance of the Group is affected by borrower credit quality

Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent in a wide range of the Group's businesses. Adverse changes in the credit quality of the Group's borrowers and counterparties or a general deterioration in UK, US, European or global economic conditions, or arising from systemic risks in the financial systems, could affect the recoverability and value of the Group's assets and require an increase in the provision for impairment losses and other provisions.

Changes in interest rates, foreign exchange rates, equity prices and other market factors affect the Group's business

The most significant market risks the Group faces are interest rate, foreign exchange and bond and equity price risks. Changes in interest rate levels, yield curves and spreads may affect the interest rate margin realised between lending and borrowing costs. Changes in currency rates, particularly in the sterling-dollar and sterling-euro exchange rates, affect the value of assets and liabilities denominated in foreign currencies and affect earnings reported by the Group's non-UK subsidiaries, mainly Citizens, RBS Greenwich Capital and Ulster Bank, and may affect income from foreign exchange dealing. The performance of financial markets may cause changes in the value of the Group's investment and trading portfolios. The Group has implemented risk management methods to mitigate and control these and other market risks to which the Group is exposed. However, it is difficult to predict with accuracy changes in economic or market conditions and to anticipate the effects that such changes could have on the Group's financial performance and business operations.

The Group's insurance businesses are subject to inherent risks involving claims

Future claims in the Group's general and life assurance business may be higher than expected as a result of changing trends in claims experience resulting from catastrophic weather conditions, demographic developments, changes in mortality and other causes outside the Group's control. Such changes would affect the profitability of current and future insurance products and services. The Group re-insures some of the risks it has assumed.

Operational risks are inherent in the Group's business

The Group's businesses are dependent on the ability to process a very large number of transactions efficiently and accurately. Operational losses can result from fraud, errors by employees, failure to document transactions properly or to obtain proper authorisation, failure to comply with regulatory requirements and Conduct of Business rules, equipment failures, natural disasters or the failure of external systems, for example, the Group's suppliers or counterparties. Although the Group has implemented risk controls and loss mitigation actions, and substantial resources are devoted to developing efficient procedures and to staff training, it is only possible to be reasonably, but not absolutely, certain that such procedures will be effective in controlling each of the operational risks faced by the Group.

Each of the Group's businesses is subject to substantial regulation and regulatory oversight. Any significant regulatory developments could have an effect on how the Group conducts its business and on the results of operations

The Group is subject to financial services laws, regulations, administrative actions and policies in each location in which the Group operates. This supervision and regulation, in particular in the UK and US, if changed could materially affect the Group's business, the products and services offered or the value of assets.

Future growth in the Group's earnings and shareholder value depends on strategic decisions regarding organic growth and potential acquisitions

The Group devotes substantial management and planning resources to the development of strategic plans for organic growth and identification of possible acquisitions, supported by substantial expenditure to generate growth in customer business. If these strategic plans do not meet with success, the Group's earnings could grow more slowly or decline.

The risk of litigation is inherent in the Group's operations

In the ordinary course of the Group's business, legal actions, claims against and by the Group and arbitrations arise; the outcome of such legal proceedings could affect the financial performance of the Group.

The Group is exposed to the risk of changes in tax legislation and its interpretation and to increases in the rate of corporate and other taxes in the jurisdictions in which it operates

The Group's activities are subject to tax at various rates around the world computed in accordance with local legislation and practice. Action by governments to increase tax rates or to impose additional taxes would reduce the profitability of the Group. Revisions to tax legislation or to its interpretation might also affect the Group's results in the future.

As discussed on page 2, the consolidated financial statements of the Group are prepared in accordance with International Financial Reporting Standards. The Group took advantage of the option in IFRS 1 to implement IAS 32, IAS 39 and IFRS 4 from 1 January 2005 without restating its 2004 income statement and balance sheet. The implementation of IAS 32, IAS 39 and IFRS on 1 January 2005 had a significant effect on the Group's balance sheet. Therefore the income statements for 2006 and 2005 as compared with 2004 and the balance sheets at 31 December 2006 and 31 December 2005 as compared with 31 December 2004 discussed in the Operating and financial review are not directly comparable.

Financial highlights

for the year ended 31 December	2006 £m	2005 £m	2004 £m
Total income	28,002	25,902	23,391
Profit before tax	9,186	7,936	7,284
Profit attributable to ordinary shareholders	6,202	5,392	4,856
Cost:income ratio (1)	44.6%	46.1%	44.3%
Basic earnings per share (pence)	194.7	169.4	157.4
Return on equity (2)	18.5%	17.5%	18.3%

at 31 December	2006 £m	2005 £m	2004 £m
Total assets	871,432	776,827	588,122
Loans and advances to customers	466,893	417,226	347,251
Deposits	516,365	453,274	383,198
Shareholders equity	40,227	35,435	33,905
Risk asset ratio tier 1	7.5%	7.6%	7.0%
total	11.7%	11.7%	11.7%

Notes:

(1) Cost:income ratio represents operating expenses expressed as a percentage of total income.

(2) Return on equity represents profit attributable to ordinary shareholders expressed as a percentage of average ordinary shareholders equity.

Operating and financial review continued

Summary consolidated income statement for the year ended 31 December 2006

	2006 £m	2005 £m	2004 £m
Net interest income	10,596	9,918	9,071
Fees and commissions receivable	7,116	6,750	6,473
Fees and commissions payable	(1,922)	(1,841)	(1,926)
Other non-interest income	6,239	5,296	4,126
Insurance premium income	6,243	6,076	6,146
Reinsurers share	(270)	(297)	(499)
Non-interest income	17,406	15,984	14,320
Total income	28,002	25,902	23,391
Operating expenses	12,480	11,946	10,362
Profit before other operating charges and impairment losses	15,522	13,956	13,029
Insurance claims	4,550	4,413	4,565
Reinsurers share	(92)	(100)	(305)
Impairment losses	1,878	1,707	1,485
Operating profit before tax	9,186	7,936	7,284
Tax	2,689	2,378	1,995
Profit for the year	6,497	5,558	5,289
Minority interests	104	57	177
Preference dividends	191	109	256
Profit attributable to ordinary shareholders	6,202	5,392	4,856
Basic earnings per ordinary share	194.7p	169.4p	157.4p
Diluted earnings per ordinary share	193.2p	168.3p	155.9p

2006 compared with 2005

Profit
Profit before tax was up 16%, from £7,936 million to £9,186 million, reflecting strong organic income growth in all divisions.

Total income
The Group achieved strong growth in income during 2006. Total income was up 8% or £2,100 million to £28,002 million.

Net interest income increased by 7% to £10,596 million and represents 38% of total income (2005 38%). Average loans and advances to customers and average customer deposits grew by 14% and 11% respectively.

Non-interest income increased by 9% to £17,406 million and represents 62% of total income (2005 62%).

Net interest margin
The Groups net interest margin at 2.53% was down from 2.60% in 2005, due mainly to the business mix effect of growth in corporate and mortgage lending and the impact of the flatter US dollar yield curve.

Operating expenses
Operating expenses rose by 4% to £12,480 million.

Integration
Integration costs were £134 million compared with £458 million in 2005. Included are costs relating to the integration of First Active and Charter One, as well as the amortisation of software costs relating to the integration of Churchill. Integration costs in 2005 included software costs relating to the acquisition of NatWest which were previously written-off as incurred under UK GAAP but under IFRS were capitalised and amortised. All such software was fully amortised by the end of 2005.

Cost:income ratio
The Groups cost:income ratio was 44.6% compared with 46.1% in 2005.

Net insurance claims
Bancassurance and general insurance claims, after reinsurance, increased by 3% to £4,458 million reflecting volume growth.

Impairment losses
Impairment losses were £1,878 million compared with £1,707 million in 2005, an increase of 10%.

Risk elements in lending and potential problem loans represented 1.57% of gross loans and advances to customers excluding reverse repos at 31 December 2006 (2005 1.60%).

Provision coverage of risk elements in lending and potential problem loans was 62% compared with 65% at 31 December 2005. This reflects amounts written-off and the changing mix from unsecured to secured exposures.

Earnings and dividends
Basic earnings per ordinary share increased by 15%, from 169.4p to 194.7p.

A final dividend of 66.4p per ordinary share is recommended, giving a total dividend for the year of 90.6p, an increase of 25%. If approved, the final dividend will be paid on 8 June 2007 to shareholders registered on 9 March 2007.

Balance sheet

Total assets were £871.4 billion at 31 December 2006, 12% higher than total assets of £776.8 billion at 31 December 2005.

Lending to customers, excluding repurchase agreements and stock borrowing (reverse repos), increased in 2006 by 10% or £35.7 billion to £404.0 billion. Customer deposits, excluding repurchase agreements and stock lending (repos), grew by 9% or £26.1 billion to £320.2 billion.

Capital ratios at 31 December 2006 were 7.5% (Tier 1) and 11.7% (Total).

Profitability

The after-tax return on ordinary equity, which is based on profit attributable to ordinary shareholders and average ordinary equity, was 18.5% compared with 17.5% in 2005.

2005 compared with 2004

Profit

The implementation of IAS 32, IAS 39 and IFRS 4 on 1 January 2005 affected the timing of recognition of income and costs, classification of debt and equity, impairment provisions and accounting for insurance contracts in 2005.

Profit before tax was up 9%, from £7,284 million to £7,936 million. Strong underlying organic income growth in all divisions and a full years contribution from acquisitions made during 2004 were partially offset by the adverse impact on income of implementing IAS 32, IAS 39 and IFRS 4 on 1 January 2005.

Total income

Total income was up 11% or £2,511 million to £25,902 million. This reflected growth in all divisions particularly Global Banking & Markets, UK Corporate Banking, Citizens and Ulster Bank and also included gain of £333 million on sale of strategic investments. The effect of implementing the requirements of IAS 32, IAS 39 and IFRS 4 on 1 January 2005 was to reduce total income. Under IFRS, certain lending fees are deferred over the life of the financial asset and interest is recognised on a constant yield basis. The implementation of IAS 32 also resulted in most of the Groups preference shares and minority interests being reclassified as debt and the interest thereon included in interest payable.

Net interest income increased by 9% to £9,918 million. Average loans and advances to customers and average customer deposits grew by 24% and 17% respectively. The effect of implementing the requirements of IAS 32, IAS 39 and IFRS 4 on 1 January 2005 was to reduce net interest income. Interest income is recognised on a constant yield basis under IFRS; under UK GAAP interest was recognised on an accrual basis. Interest payable also increased due to the reclassification of the Groups preference shares and minority interests.

Non-interest income increased by 12% to £15,984 million with good growth in banking fee income, financial markets income and insurance premium income. Non-interest income represents 62% of total income. The effect of implementing the requirements of IAS 39 and IFRS 4 on 1 January 2005 was to reduce non-interest income, principally due to the deferral of certain lending fees.

Operating expenses

Operating expenses rose by 15% to £11,946 million, partly due to the implementation of IAS 39 and IFRS 4 on 1 January 2005. Operating expenses included loss on sale of subsidiaries of £93 million.

Integration

Integration costs were £458 million compared with £520 million in 2004. Included are software costs relating to the integration of NatWest which were written-off as incurred under UK GAAP but on transition to IFRS were capitalised and amortised. All such software is now fully amortised. The balance principally relates to the integration of Churchill, First Active and Citizens acquisitions, including Charter One which was acquired in August 2004.

Cost:income ratio

The Groups cost:income ratio in 2005 was 46.1% (2004 44.3%), reflecting the impact on income in 2005 of IAS 32, IAS 39 and IFRS 4 and the first full year of acquisitions, particularly Charter One.

Net insurance claims

Bancassurance and general insurance claims after reinsurance, which under IFRS include maturities and surrenders, increased by 1% to £4,313 million.

Impairment losses

Impairment losses were £1,707 million compared with £1,485 million in 2004. Overall credit quality remained strong in 2005, with improvements in Global Banking & Markets and UK Corporate Banking partly offsetting higher impairment losses in Retail Markets. The effect of implementing the requirements of IAS 39 on 1 January 2005 was to increase loan impairment losses.

Risk elements in lending and potential problem loans represented 1.60% of gross loans and advances to customers excluding reverse repos at 31 December 2005 (31 December 2004 1.92%).

Provision coverage of risk elements in lending and potential problem loans was 65% compared with 72% at 31 December 2004. This reflects amounts written-off and the changing mix from unsecured to secured exposures.

Earnings and dividends

Basic earnings per ordinary share increased by 8% from 157.4p to 169.4p.

A final dividend of 53.1p per ordinary share, up 29% was approved, giving a total dividend for the year of 72.5p, an increase of 25%. The final dividend was paid on 9 June 2006 to shareholders registered on 10 March 2006.

Balance sheet

Total assets of £776.8 billion at 31 December 2005 were up £188.7 billion, 32%, compared with 31 December 2004, with £108.4 billion of this increase arising from the implementation of IAS 32, IAS 39 and IFRS 4 on 1 January 2005, and the balance reflecting business growth.

Loans and advances to customers were up £70.0 billion, 20%, at £417.2 billion of which £33.9 billion resulted from the implementation of IAS 32 and IAS 39, mainly as a result of the grossing up of previously netted customer balances. Excluding this and a decrease in reverse repos, down 24%, £15.7 billion to £48.9 billion, customer lending was up £51.8 billion, 16%, reflecting organic growth across all divisions.

Customer accounts were up £59.5 billion, 21% at £342.9 billion with £31.7 billion arising from the implementation of IAS 32 and IAS 39, largely reflecting the grossing up of previously netted deposits. Excluding this and repos, which decreased £5.7 billion, 11% to £48.8 billion, deposits rose by £33.5 billion, 13%, to £294.1 billion with good growth in all divisions.

Capital ratios at 31 December 2005 were 7.6% (Tier 1) and 11.7% (Total).

Profitability

The after-tax return on ordinary equity, which is based on profit attributable to ordinary shareholders and average ordinary equity was 17.5% (2004 - 18.3%).

Operating and financial review continued

Analysis of results
Net interest income

	2006 £m	2005 £m	2004 £m
Interest receivable	24,688	21,331	16,632
Interest payable	(14,092)	(11,413)	(7,561)
Net interest income	10,596	9,918	9,071

	%	%	%
Gross yield on interest-earning assets of the banking business	5.90	5.59	5.21
Cost of interest-bearing liabilities of the banking business	(3.85)	(3.36)	(2.70)
Interest spread of the banking business	2.05	2.23	2.51
Benefit from interest-free funds	0.48	0.37	0.33
Net interest margin of the banking business	2.53	2.60	2.84

Yields, spreads and margins of the banking business	%	%	%
Gross yield (1)			
Group	5.90	5.59	5.21
UK	6.13	6.06	5.58
Overseas	5.50	4.74	4.38
Interest spread (2)			
Group	2.05	2.23	2.51
UK	2.37	2.45	2.56
Overseas	1.47	1.87	2.48
Net interest margin (3)			
Group	2.53	2.60	2.84
UK	2.68	2.75	2.85
Overseas	2.26	2.32	2.83
The Royal Bank of Scotland plc base rate (average)	4.64	4.65	4.38
London inter-bank three month offered rates (average):			
Sterling	4.85	4.76	4.64
Eurodollar	5.20	3.56	1.62
Euro	3.08	2.18	2.11

Notes:

(1) Gross yield is the interest rate earned on average interest-earning assets of the banking business.

(2) Interest spread is the difference between the gross yield and the interest rate paid on average interest-bearing liabilities of the banking business.

(3) Net interest margin is net interest income of the banking business as a percentage of average interest-earning assets of the banking business.

Average balance sheet and related interest

	2006			2005			
	Average balance £m	Interest £m	Rate %	Average balance £m	Interest £m	Rate %	Avera bala
Assets							
Treasury bills and other eligible bills UK	2,059	90	4.37	3,160	138	4.37	8
Overseas	70	3	4.29	55	2	3.64	
Loans and advances to banks UK	15,934	681	4.27	15,477	649	4.19	13,6
Overseas	7,237	237	3.27	9,422	259	2.75	9,1
Loans and advances to customers UK	239,086	15,141	6.33	212,156	13,453	6.34	186,1
Overseas	121,092	6,977	5.76	104,579	5,206	4.98	69,1
Debt securities UK	10,757	508	4.72	14,731	630	4.28	21,8
Overseas	21,962	1,051	4.79	22,299	994	4.46	18,1
Total interest-earning assets banking business (2,3)	418,197	24,688	5.90	381,879	21,331	5.59	319,0
trading business (4)	202,408			172,990			133,3
Total interest-earning assets	620,605			554,869			452,3
Non-interest-earning assets (2,3)	213,297			182,179			70,4
Total assets	833,902			737,048			522,8
Percentage of assets applicable to overseas operations	35.2%			35.3%			32.
Liabilities and shareholders equity							
Deposits by banks UK	35,985	1,393	3.87	34,742	1,192	3.43	35,0
Overseas	28,772	1,228	4.27	27,383	891	3.25	16,4
Customer accounts: demand deposits UK	86,207	2,428	2.82	73,653	2,057	2.79	67,5
Overseas	13,113	441	3.36	13,823	299	2.16	11,5
Customer accounts: savings deposits UK	30,933	1,058	3.42	26,727	778	2.91	23,1
Overseas	19,766	529	2.68	21,700	381	1.76	18,3
Customer accounts: other time deposits UK	67,126	2,807	4.18	60,350	2,325	3.85	51,5
Overseas	36,177	1,636	4.52	32,024	979	3.06	20,7
Debt securities in issue UK	45,829	2,210	4.82	42,745	1,771	4.14	41,0
Overseas	25,249	1,076	4.26	19,621	633	3.23	12,3
Subordinated liabilities UK	23,873	1,226	5.14	23,948	1,117	4.66	17,9
Overseas	2,639	160	6.06	2,642	154	5.83	2
Internal funding of trading business UK	(44,475)	(1,893)	4.26	(37,628)	(1,125)	2.99	(35,3
Overseas	(4,930)	(207)	4.20	(2,186)	(39)	1.78	(7
Total interest-bearing liabilities banking business (2,3)	366,264	14,092	3.85	339,544	11,413	3.36	279,8

trading business (4)	204,810	172,744	131,7
Total interest-bearing liabilities	571,074	512,288	411,6
Non-interest-bearing liabilities			
Demand deposits UK	17,909	17,484	17,1
Overseas	11,668	11,181	9,1
Other liabilities (3,4)	196,375	163,147	53,8
Shareholders equity	36,876	32,948	31,0
Total liabilities and shareholders equity	833,902	737,048	522,8
Percentage of liabilities applicable to overseas operations	32.3%	33.5%	30.

Notes:

(1) The analysis into UK and Overseas has been compiled on the basis of location of office.

(2) Interest-earning assets and interest-bearing liabilities include the Retail bancassurance assets and liabilities attributable to policyholders.

(3) Interest income and interest expense do not include interest on financial assets and liabilities designated as at fair value through profit or loss.

(4) Interest receivable and interest payable on trading assets and liabilities are included in income from trading activities.

Operating and financial review continued

Analysis of change in net interest income volume and rate analysis

Volume and rate variances have been calculated based on movements in average balances over the period and changes in interest rates on average interest-earning assets and average interest-bearing liabilities. Changes due to a combination of volume and rate are allocated pro rata to volume and rate movements.

	2006 over 2005			2005 over 2004		
	Increase/(decrease) due to changes in:			Increase/(decrease) due to changes in:		
	Average volume £m	Average rate £m	Net change £m	Average volume £m	Average rate £m	Net change £m
Interest-earning assets						
Treasury bills and other eligible bills						
UK	(48)		(48)	101	3	104
Overseas	1		1		1	1
Loans and advances to banks						
UK	19	13	32	72	48	120
Overseas	(66)	44	(22)	6	(11)	(5)
Loans and advances to customers						
UK	1,705	(17)	1,688	1,620	717	2,337
Overseas	887	884	1,771	1,748	257	2,005
Debt securities						
UK	(183)	61	(122)	(273)	177	(96)
Overseas	(15)	72	57	184	49	233
Total interest receivable of the banking business						
UK	1,493	57	1,550	1,520	945	2,465
Overseas	807	1,000	1,807	1,938	296	2,234
	2,300	1,057	3,357	3,458	1,241	4,699
Interest-bearing liabilities						
Deposits by banks						
UK	(44)	(157)	(201)	10	(129)	(119)
Overseas	(47)	(290)	(337)	(326)	(167)	(493)
Customer accounts: demand deposits						
UK	(353)	(18)	(371)	(151)	(338)	(489)
Overseas	16	(158)	(142)	(33)	(119)	(152)
Customer accounts: savings deposits						
UK	(133)	(147)	(280)	(102)	(51)	(153)
Overseas	37	(185)	(148)	(50)	(79)	(129)
Customer accounts: other time deposits						

UK	(274)	(208)	(482)	(313)	(313)	(626)
Overseas	(140)	(517)	(657)	(313)	(187)	(500)
Debt securities in issue						
UK	(134)	(305)	(439)	(58)	(362)	(420)
Overseas	(209)	(234)	(443)	(180)	(224)	(404)
Subordinated liabilities						
UK	4	(113)	(109)	(254)	(198)	(452)
Overseas	—	(6)	(6)	(140)	1	(139)
Internal funding of trading business						
UK	231	537	768	62	143	205
Overseas	81	87	168	27	(8)	19
Total interest payable of the banking business						
UK	(703)	(411)	(1,114)	(806)	(1,248)	(2,054)
Overseas	(262)	(1,303)	(1,565)	(1,015)	(783)	(1,798)
	(965)	(1,714)	(2,679)	(1,821)	(2,031)	(3,852)
Movement in net interest income						
UK	790	(354)	436	714	(303)	411
Overseas	545	(303)	242	923	(487)	436
	1,335	(657)	678	1,637	(790)	847

Non-interest income

	2006 £m	2005 £m	2004 £m
Fees and commissions receivable	7,116	6,750	6,473
Fees and commissions payable	(1,922)	(1,841)	(1,926)
Income from trading activities	2,675	2,343	1,988
Other operating income	3,564	2,953	2,138
	11,433	10,205	8,673
Insurance premium income	6,243	6,076	6,146
Reinsurers share	(270)	(297)	(499)
	5,973	5,779	5,647
	17,406	15,984	14,320

2006 compared with 2005

Non-interest income increased by £1,422 million, 9% to £17,406 million reflecting strong organic growth in all divisions especially Global Banking & Markets, up 25% and Wealth Management, up 17%. Non-interest income represents 62% of total income (2005 62%). Excluding general insurance premium income, non-interest income rose by 12% or £1,228 million to £11,433 million.

Within non-interest income, fees and commissions receivable increased by 5% or £366 million, to £7,116 million, while fees and commissions payable increased by 4%, £81 million to £1,922 million.

Income from trading activities, which primarily arises from providing customers with debt and risk management products in interest rate, currency and credit, was up £332 million, 14%, reflecting increased customer volumes.

Other operating income increased by 21%, £611 million to £3,564 million. This was principally due to growth in income from rental and asset-backed activities and principal investments in Corporate Markets.

General insurance premium income, after reinsurance, rose by 3%, or £194 million to £5,973 million with good growth in motor policies in the UK and Continental Europe.

2005 compared with 2004

Non-interest income increased by £1,664 million, 12% to £15,984 million reflecting strong performances in Global Banking & Markets, UK Corporate Banking and Citizens, and good growth in banking fee income, financial markets income and insurance premium income. The effect of implementing IAS 39 and IFRS 4 on 1 January 2005 was to reduce non-interest income.

Within non-interest income, fees and commissions receivable increased by 4% or £277 million, to £6,750 million, while fees and commissions payable decreased by £85 million to £1,841 million. Under IFRS, certain lending fees are deferred over the life of the financial asset.

Income from trading activities, which primarily arises from providing customers with debt and risk management products in interest rate, currency and credit, was up £355 million, 18%. The increase on 2004 reflected higher customer volumes.

Other operating income increased by 38%, £815 million to £2,953 million. This was principally due to higher income from rental assets, increased bancassurance income, realised investment securities gains and the gain on sale of strategic investments.

General insurance premium income, after reinsurance, rose by 2%, or £132 million to £5,779 million reflecting volume growth in motor and home insurance products.

Operating and financial review continued

Operating expenses

	2006 £m	2005 £m	2004 £m
Administrative expenses:			
Staff costs	6,723	5,992	5,188
Premises and equipment	1,421	1,313	1,177
Other administrative expenses	2,658	2,816	2,323
Total administrative expenses	10,802	10,121	8,688
Depreciation and amortisation	1,678	1,825	1,674
	12,480	11,946	10,362

2006 compared with 2005

Operating expenses rose by 4% to £12,480 million to support the strong growth in business volumes.

Staff costs were up £731 million, 12% to £6,723 million reflecting growth and expansion of activities in Corporate Markets, where the number of staff increased by 1,700.

Premises and equipment expenses increased by £108 million, 8% to £1,421 million reflecting the continuation of our branch network improvement programme and ongoing investment in our major operational centres.

Other administrative expenses, down 6%, £158 million to £2,658 million reflected efficiency improvements whilst supporting higher business volumes and lower costs in relation to the integration of Churchill, First Active and Citizens' acquisitions.

The Group's ratio of operating expenses to total income was 44.6% compared with 46.1% in 2005.

2005 compared with 2004

Operating expenses rose by 15% to £11,946 million to support growth in business volumes and included the loss on sale of subsidiaries.

Staff costs were up £804 million, 15% to £5,992 million reflecting business growth. The number of staff increased by 400 to 137,000.

Premises and equipment expenses increased by £136 million, 12% to £1,313 million reflecting our programme of investment both in the branch networks and in our major operational centres.

Other administrative expenses, up 21%, £493 million reflected business volume growth and ongoing expenditure on regulatory projects.

The Group's ratio of operating expenses to total income was 46.1% compared with 44.3% in 2004, partly due to the full year effect of acquisitions and the impact of implementing IAS 32, IAS 39 and IFRS 4 on 1 January 2005.

Integration costs

	2006 £m	2005 £m	2004 £m
Staff costs	76	148	83
Premises and equipment	10	39	35
Other administrative expenses	32	131	149
Depreciation and amortisation	16	140	253
	134	458	520

2006 compared with 2005

Integration costs were £134 million compared with £458 million in 2005 comprising amortisation of internally developed software and other expenditure. Software costs were previously written-off as incurred under UK GAAP but under IFRS are now amortised over 3-5 years. All software relating to the NatWest integration was fully amortised by the end of 2005. The balance of integration costs principally relates to the integration of Churchill, First Active and Citizens’ acquisitions, including Charter One which was acquired in August 2004.

Accruals in relation to integration costs are set out below.

	At 31 December 2005 £m	Currency translation adjustments £m	Charge to income statement £m	Utilised during the year £m	At 31 December 2006 £m
Staff costs	32	(1)	76	(84)	23
Premises and equipment	14	(1)	10	(23)	–
Other	26	(1)	48	(65)	8
	72	(3)	134	(172)	31

2005 compared with 2004

Integration costs were £458 million compared with £520 million in 2004 comprising amortisation of internally developed software and other expenditure. Software costs were previously written off as incurred under UK GAAP but under IFRS are now amortised over 3-5 years. All software relating to the NatWest integration was fully amortised by the end of 2005. The balance of integration costs principally relates to the integration of Churchill, First Active and Citizens’ acquisitions, including Charter One which was acquired in August 2004.

Operating and financial review continued

Impairment losses

	2006 £m	2005 £m	2004 £m
New impairment losses	2,093	1,879	1,629
less: recoveries of amounts previously written-off	(215)	(172)	(144)
Charge to income statement	1,878	1,707	1,485
Comprising:			
Loan impairment losses	1,877	1,703	1,402
Other impairment losses	1	4	83
Charge to income statement	1,878	1,707	1,485

2006 compared with 2005

Impairment losses were £1,878 million compared with £1,707 million in 2005. New impairment losses were up 11%, £214 million to £2,093 million. Recoveries of amounts previously written-off were up £43 million, 25% to £215 million. Consequently the net charge to the income statement was up £171 million, 10% to £1,878 million. Improvements in Corporate Markets reflecting a benign credit environment partly offset higher impairment losses in Retail Markets and Citizens.

Total balance sheet provisions for impairment amounted to £3,935 million compared with £3,887 million in 2005.

Total provision coverage (the ratio of total balance sheet provisions for impairment to total risk elements in lending) decreased from 65% to 62%. The ratio of total balance sheet provisions for impairment to total risk elements in lending and potential problem loans also decreased to 62% compared with 65% in 2005. This reflects amounts written-off and the changing mix from unsecured to secured exposure.

2005 compared with 2004

Impairment losses were £1,707 million compared with £1,485 million in 2004 with higher provisions in Retail Markets partly offset by improvements in Global Banking & Markets and UK Corporate Banking. Following the implementation of IAS 39 on 1 January 2005, loan impairment losses are based on the discounted value of expected recoveries. As a result, provisions are higher initially but the difference between the discounted and undiscounted amounts emerges as interest income over the recovery period.

New impairment losses were up 15%, £250 million to £1,879 million. Recoveries of amounts previously written off were up £28 million, 19% to £172 million. Consequently the net charge to the income statement was up £222 million, 15% to £1,707 million.

Total balance sheet provisions for impairment amounted to £3,887 million compared with £4,174 million at 31 December 2004. Total provision coverage (the ratio of total balance sheet provisions for impairment to total risk elements in lending) decreased from 76% to 65%.

The ratio of total balance sheet provisions for impairment to total risk elements in lending and potential problem loans decreased to 65% compared with 72% at 31 December 2004. This reflects amounts written-off and the changing mix from unsecured to secured exposure.

Other impairment losses were £4 million compared with £83 million in 2004.

Taxation

	2006 £m	2005 £m	2004 £m
Tax	2,689	2,378	1,995
	%	%	%
UK corporation tax rate	30.0	30.0	30.0
Effective tax rate	29.3	30.0	27.4

The actual tax charge differs from the expected tax charge computed by applying the standard rate of UK corporation tax as follows:

	2006 £m	2005 £m	2004 £m
Expected tax charge	2,756	2,381	2,185
Interest on subordinated debt not allowable for tax	58	79	
Non-deductible items	230	230	110
Non-taxable items	(251)	(166)	(128)
Taxable foreign exchange movements	5	(10)	(10)
Foreign profits taxed at other rates	63	77	49
Unutilised losses brought forward and carried forward	14	(5)	6
Adjustments in respect of prior periods	(186)	(208)	(217)
Actual tax charge	2,689	2,378	1,995

Operating and financial review continued

Divisional performance

The results of each division before amortisation of purchased intangible assets, integration costs and net gain on sale of strategic investments and subsidiaries and, where appropriate, before allocation of manufacturing costs (Contribution) and after allocation of manufacturing costs (Operating profit before tax) are shown below. The Group continues to manage costs where they arise, with customer-facing divisions controlling their direct expenses whilst Manufacturing is responsible for shared costs. The Group does not allocate these shared costs between divisions in the day-to-day management of its businesses, and the way in which divisional results are presented reflects this. The results below include an allocation of Manufacturing costs to the customer-facing divisions on a basis management considers to be reasonable.

	2006			2005		
	Contribution £m	Allocation of Manufacturing costs £m	Operating profit before tax £m	Contribution £m	Allocation of Manufacturing costs £m	Operating profit before tax £m
Global Banking & Markets	3,933	(143)	3,790	3,179	(138)	3,041
UK Corporate Banking	2,189	(427)	1,762	1,986	(414)	1,572
Retail Markets						
- Retail	3,867	(1,568)	2,299	3,781	(1,517)	2,264
- Wealth Management	497	(143)	354	410	(138)	272
Total Retail Markets	4,364	(1,711)	2,653	4,191	(1,655)	2,536
Ulster Bank	602	(214)	388	530	(207)	323
Citizens	1,582	-	1,582	1,575	-	1,575
RBS Insurance	964	(214)	750	935	(207)	728
Manufacturing	(2,852)	2,852	-	(2,758)	2,758	-
Central items	(1,368)	(143)	(1,511)	(1,387)	(137)	(1,524
Profit before amortisation of purchased intangible assets, integration costs and net gain on sale of strategic investments and subsidiaries	9,414	-	9,414	8,251	-	8,251
Amortisation of purchased intangible assets	(94)	-	(94)	(97)	-	(97
Integration costs	(134)	-	(134)	(458)	-	(458
Net gain on sale of strategic investments and subsidiaries	-	-	-	240	-	240
Operating profit before tax	9,186	-	9,186	7,936	-	7,936

The performance of each of the divisions is reviewed on pages 20 to 34.

Operating and financial review continued

Global Banking & Markets

	2006 £m	2005 £m	2004 £m
Net interest income from banking activities	1,629	1,486	1,269
Funding costs of rental assets	(519)	(452)	(370)
Net interest income	1,110	1,034	899
Net fees and commissions receivable	861	678	674
Income from trading activities	2,379	2,061	1,766
Income from rental assets	1,196	1,074	924
Other operating income	1,280	744	350
Non-interest income	5,716	4,557	3,714
Total income	6,826	5,591	4,613
Direct expenses			
staff costs	1,975	1,518	1,246
other	427	357	318
operating lease depreciation	406	398	360
	2,808	2,273	1,924
Impairment losses	85	139	311
Contribution	3,933	3,179	2,378
Allocation of Manufacturing costs	143	138	128
Operating profit before tax	3,790	3,041	2,250

	31 December 2006 £bn	31 December 2005 £bn	1 January 2005 £bn
Total assets*	383.6	330.9	291.3
Loans and advances to customers gross*			
banking book	94.3	82.0	70.5
trading book	15.4	11.8	10.1
Rental assets	12.2	11.9	10.3
Customer deposits*	54.1	44.7	45.3

Risk-weighted assets	138.1	120.0	104.9

* excluding repos and reverse repos

2006 compared with 2005

Global Banking & Markets performed strongly in 2006, delivering excellent growth in income while continuing to build our strong international franchise. Total income rose by 22% to £6,826 million, contribution by 24% to £3,933 million and operating profit by 25% to £3,790 million.

GBM is a leading provider of debt financing and risk management solutions covering the origination, structuring and distribution of a wide range of assets. In 2006 we arranged over $450 billion of financing for our corporate and institutional customers, up 17% from 2005. We ranked first among managers of global asset-backed and mortgage-backed securitisations and fourth among managers of global syndicated loans, while among managers of international bonds we moved from thirteenth place to eighth. These league table positions demonstrate our success in broadening and deepening our franchise.

In 2006 we have further invested in extending our product capabilities and our worldwide reach. Income in North America rose by 18% in local currency, despite flat revenues in our US residential mortgage-backed securities business, as the investments we have made in our debt capital markets, loan markets, rates and credit trading businesses have borne fruit.

In Europe, income increased by 26% in local currency as a result of good performances in Germany, France, Spain, Italy and the Nordic region. We participated in many of the largest cross-border financings in 2006. Asia-Pacific, too, showed marked progress, with income increasing by 35% in US dollar terms. We have established a promising presence in the region, building our product capability and client relationships.

Net interest income rose by 7% to £1,110 million, representing 16% of total GBM income. Average loans and advances to customers increased by 20% as we further expanded our customer base outside the UK.

Net fee income rose by 27% to £861 million, reflecting our top tier position in arranging, structuring and distributing large scale private and public financings. We have increased our customer penetration, and in 2006 were the third most active underwriter of bonds for European, including UK, corporates.

Income from trading activities continued to grow steadily, rising by 15% to £2,379 million as a result of good volumes of debt and risk management products provided to our customers. A strong performance in credit products was supplemented by growth in our broadening product range, including equity derivatives and structured credit, partially offset by the impact of a slower US mortgage-backed securities market. Average trading book value at risk remained modest at £14.2 million.

Our rental and other asset-based activities have achieved continuing success in originating, structuring, financing and managing physical assets such as aircraft, trains, ships and real estate for our customers. This success has driven good growth in income from rental assets, which increased to £1,196 million from £1,074 million.

These businesses also generate value through the ownership of a portfolio of assets which we manage actively. Good results from these activities, as well as from principal investments where we work with our corporate customers and with financial sponsors, leveraging our financial capability to structure and participate in a wide variety of investment opportunities, were reflected in other operating income, which increased to £1,280 million from £744 million in 2005.

We have maintained good cost discipline while continuing to invest in extending our geographical footprint, our infrastructure and our product range. Total expenses grew by 22% to £2,951 million. Variable performance-related compensation increased and now accounts for 41% of total costs.

Portfolio risk remained stable and the corporate credit environment remained benign. Impairment losses fell to £85 million, with the distribution of impairments over the course of the year reflecting recoveries in the first half.

Average risk-weighted assets grew by 11% and the ratio of operating profit to average risk-weighted assets improved from 2.6% to 2.9%.

2005 compared with 2004

An excellent performance from our Global Banking & Markets customer segment in 2005 shows the fruits of the global platform we have built over the last five years, with good growth in all major geographies and across-the-board success in income generation from our core banking, structured finance and financial markets activities.

Total income increased by 21% to £5,591 million, with contribution up 34% to £3,179 million, benefiting from cost discipline and continuing benign credit conditions. Operating profit before tax rose by 35% to £3,041 million.

Debt underwriting volumes remained strong throughout the course of the year, reflecting our involvement in many of the largest financings in the UK and Europe for both large corporates and private equity sponsors. We were the fourth most active bank worldwide in arranging and underwriting bank lending in 2005. A strong distribution performance brought weighted risk assets to £120 billion at year-end, up 14% over the year and back to a more consistent trend level than the amount at 30 June 2005.

Non-interest income grew by 23% to £4,557 million and now accounts for 82% of Global Banking & Markets revenues.

We recorded good growth in fees earned from customer services in risk management, financial structuring and debt-raising. A strong performance from RBS Greenwich Capital, which has been brought together with other Global Banking & Markets activities in North America, contributed to steady growth in income from trading activities. Customer volumes were higher across all products and particularly good in our credit markets businesses. Average trading Value at Risk was held steady at a very conservative level, £12 million.

Our continuing success in aircraft, train, ship and hotel leasing delivered good growth in net income from rental assets. Our operating income grew strongly, with our structured finance investment portfolio producing good realised gains, notably in the second half of the year.

Growth in direct expenses was 18%, reflecting variable performance-related costs.

Operating and financial review continued

UK Corporate Banking

	2006 £m	2005 £m	2004 £m
Net interest income	2,111	1,904	1,639
Non-interest income	1,342	1,265	1,347
Total income	3,453	3,169	2,986
Direct expenses			
staff costs	562	488	458
other	183	164	140
operating lease depreciation	330	335	320
	1,075	987	918
Impairment losses	189	196	270
Contribution	2,189	1,986	1,798
Allocation of Manufacturing costs	427	414	383
Operating profit before tax	1,762	1,572	1,415

	31 December 2006 £bn	31 December 2005 £bn	1 January 2005 £bn
Total assets*	88.7	78.3	68.1
Loans and advances to customers gross*	86.8	76.7	66.4
Customer deposits*	78.4	66.4	55.4
Risk-weighted assets	93.1	82.6	73.5

* excluding repos and reverse repos

2006 compared with 2005

UK Corporate Banking had a successful year across all its businesses, strengthening its market leading positions in corporate and commercial banking and building good momentum in the provision of a broadening range of financing and risk management services to its customer base. As a result UKCB increased its total income by 9% to £3,453 million and contribution by 10% to £2,189 million. Operating profit before tax rose by 12% to £1,762 million.

Net interest income grew by 11% to £2,111 million. We achieved an 18% increase in average loans and advances to customers, with good growth across all customer segments. We increased average customer deposits by 21%, demonstrating the attractiveness of our range of deposit products for commercial and corporate customers. Changes in the deposit mix and some narrowing of lending margins, principally in the first half of the year, led to a modest decline in UKCBs net interest margin.

Non-interest income rose by 6% to £1,342 million, reflecting good growth in origination fees and improved distribution of trade and invoice finance and interest rate and foreign exchange products.

Total expenses rose by 7% to £1,502 million. The increase in direct expenses, excluding operating lease depreciation, reflected the recruitment of additional relationship managers and other staff to strengthen the quality of service provided to our expanding customer base, as well as further investment in our electronic banking proposition.

Impairment losses were 4% lower than in 2005 at £189 million. Portfolio risk remained stable and the credit environment benign.

2005 compared with 2004

UK Corporate Banking generated good results in 2005, building on the strength of its UK franchise. We maintained our market-leading positions in corporate and commercial banking, asset finance and invoice finance. Total income rose by 6% to £3,169 million, whilst contribution rose by 10% to £1,986 million. Operating profit before tax rose by 11% to £1,572 million.

Net interest income increased 16% to £1,904 million as a result of strong growth in average lending and in average customer deposits.

Non-interest income declined by 6% to £1,265 million, reflecting the effect of IAS 39 on recognition of fee income being partially offset by our continued success in cross-selling our full range of products and services to customers. Our business has benefited from the co-location of our asset finance and invoice finance managers with our corporate and commercial banking operations.

Direct expense growth was 8% which included a further investment in customer-facing staff.

Impairment losses were 27% lower than in 2004 at £196 million, reflecting a further improvement in our credit metrics.

Retail Markets

Retail Markets was established in June 2005 to strengthen co-ordination and delivery of our multi-brand retail strategy across our product range, and comprises Retail and Wealth Management.

	2006 £m	2005 £m	2004 £m
Net interest income	4,711	4,510	4,261
Non-interest income	3,926	3,746	3,899
Total income	8,637	8,256	8,160
Direct expenses			
staff costs	1,648	1,565	1,458
other	793	829	839
	2,441	2,394	2,297
Insurance net claims	488	486	702
Impairment losses	1,344	1,185	720
Contribution	4,364	4,191	4,441
Allocation of Manufacturing costs	1,711	1,655	1,530
Operating profit before tax	2,653	2,536	2,911

	31 December 2006 £bn	31 December 2005 £bn	1 January 2005 £bn
Total banking assets	119.9	114.4	104.9
Loans and advances to customers gross			
mortgages	69.8	64.6	56.9
personal	21.0	21.5	20.2
cards	9.1	9.6	9.4
business	18.1	16.7	15.9
Customer deposits*	115.6	105.3	97.0
Investment management assets excluding deposits	34.9	31.4	26.6
Risk-weighted assets	78.4	80.6	76.5

* customer deposits exclude bancassurance

2006 compared with 2005

Retail Markets achieved a good performance in 2006, with total income rising by 5% to £8,637 million. Contribution increased by 4% to £4,364 million and operating profit before tax by 5% to £2,653 million.

Responding to evolving demand from its customers, Retail Markets has added to its capabilities in deposits and investment products and has been rewarded by strong growth in these areas. Lending growth has been centred on high quality residential mortgages and small business loans, while personal unsecured lending was flat, as we limited our activity in the direct loans market and customer demand remained subdued. We have used our full range of brands to address markets flexibly, focusing on the most appropriate products and channels in the light of prevailing market conditions.

Expenses have been kept under tight control, with additional investment in our business offset by efficiency gains and the benefits of combining Retail Banking and Direct Channels into a unified business.

Customer recruitment has been centred on our branch channels, where we have achieved good growth in savings accounts and are joint market leader for personal current accounts. Our commitment to customer service, through the largest network of branches and ATMs in the UK, is reflected in our industry-leading customer satisfaction ratings.

Average risk-weighted assets fell by 1%, reflecting a change in business mix toward mortgage lending as well as careful balance sheet management, including increased use of securitisations.

2005 compared with 2004

Total income increased by 1% to £8,256 million and contribution decreased by 6% to £4,191 million, with good discipline on costs helping to partially offset increased impairment losses on unsecured lending. Operating profit before tax fell by 13% to £2,536 million.

At the end of 2004 we referred to the changes being seen in the retail markets with the consumer transitioning from an environment which had seen several years of very fast growth in consumer lending to an increased emphasis on savings and investment.

As a consequence, we planned to refocus our strategy to grow our sales of deposit and bancassurance products faster than the market, to exploit our potential for building profitable market share in the mortgage market and to concentrate more on the development of our branch franchise, building on our strong service proposition. During 2005 this transition has gathered momentum and we have achieved good progress in our strategies.

Branch deposit balances outgrew the market and our bancassurance sales accelerated strongly, with annual premium equivalent sales 25% higher than in 2004. Our share of net mortgage lending, assisted by the launch of the First Active brand, reached 8% in 2005. Our credit card business, meanwhile, made excellent headway in marketing through branch channels; we gained 60% more credit card customers in our core NatWest and RBS brands in the second half than in the same period of 2004.

Operating and financial review continued

Retail

	2006 £m	2005 £m	2004 £m
Net interest income	4,211	4,068	3,858
Non-interest income	3,492	3,374	3,529
Total income	7,703	7,442	7,387
Direct expenses			
– staff costs	1,349	1,307	1,196
– other	656	696	705
	2,005	2,003	1,901
Insurance net claims	488	486	702
Impairment losses	1,343	1,172	702
Contribution	3,867	3,781	4,082
Allocation of Manufacturing costs	1,568	1,517	1,402
Operating profit before tax	2,299	2,264	2,680

	31 December 2006 £bn	31 December 2005 £bn	1 January 2005 £bn
Total banking assets	108.8	104.3	95.8
Loans and advances to customers – gross			
– mortgages	65.6	61.1	53.5
– personal	17.7	17.7	17.0
– cards	9.0	9.5	9.3
– business	16.9	16.3	15.3
Customer deposits*	87.1	79.8	74.7
Risk-weighted assets	71.9	74.5	70.5

* customer deposits exclude bancassurance

2006 compared with 2005

Retail has delivered a good performance in 2006, achieving 4% growth in total income to £7,703 million. Contribution was up by 2% to £3,867 million, and operating profit before tax by 2% to £2,299 million.

We have advanced in personal banking, with good growth in savings and investment products combined with effective cost control and improvements in the quality of our lending book. Credit card recruitment and unsecured personal lending continues to be focused on lower risk segments, with reduced emphasis on acquisition through direct marketing.

We have continued to expand our customer franchise, growing our personal current account base by 232,000 in 2006 as a result of our sustained focus on quality and customer service. We continue to have the highest share of customers switching current accounts from other banks, and are now joint leader in the personal current account market. RBS is first and NatWest is joint second among major high street banks in Great Britain for the percentage of main current account customers that are "extremely satisfied" overall.

Net interest income increased by 4% to £4,211 million, with faster growth in deposits helping to mitigate lower unsecured lending volumes. Net interest margin improved slightly in the second half.

Average customer deposit balances were 9% higher, driven by personal savings balances up 12% and accelerating growth in business deposits, up 7%. Average mortgage lending was up 8%, with stronger volumes in the second half leading to a 7% market share of net lending in that period. Our offset mortgage product continues to perform well. For the year as a whole, average personal unsecured and credit card lending was flat, reflecting the slower UK consumer demand and our concentration on quality business with existing customers. In the second half we further reduced our activity in the direct loans market, but unsecured balances from our RBS and NatWest customers are broadly in line with the first half. Average business lending rose 5%, reflecting our cautious credit stance.

Non-interest income rose by 4% to £3,492 million. There was strong growth in our investments and private banking businesses as well as business banking fees, mitigating the slowdown in personal loan related insurance income.

Despite investments for future growth, total expenses rose by just 2%, to £3,573 million, whilst direct expenses were held flat at £2,005 million. Staff costs increased by 3% to £1,349 million, reflecting sustained investment in customer service and the expansion of our bancassurance and investment businesses. We continue to make efficiency gains as a result of the consolidation of our retail businesses. Other costs, such as marketing expenses, fell by 6% to £656 million, also benefiting from consolidation.

Impairment losses increased by 15% to £1,343 million, but were lower in the second half of the year than in the first. The year-on-year change in impairment losses slowed from 18% in the first half to 11% in the second half. Credit card arrears have stabilised, while the rate of increase in arrears on unsecured personal loans continued to slow. Mortgage arrears remain very low – the average loan-to-value ratio of Retail's mortgages was 46% overall and 64% on new mortgages written in 2006. Small business credit quality remains steady.

Bancassurance

Bancassurance has had an excellent year with sales increasing by 56% to £267 million annual premium equivalent. The growth reflects the continued increase in focus on the recruitment of Financial Planning Managers, up 25% and productivity levels, up 43%. Increased sales of collective investments on the back of a successful ISA season and strong individual pensions growth, boosted by A-Day, helped underpin the outturn. Sales of guaranteed bonds were also particularly strong, and helped support a new business margin which improved significantly over the period. The product proposition was strengthened across all lines. Latest market share data shows an increase from 6.6% to 9.0% . On a UK GAAP embedded value basis for life assurance, investment contracts and open ended investment companies, adjusted for investment market volatility, pre tax profit was £78 million compared with £42 million in 2005.

Net claims, which include maturities, surrenders and liabilities to policyholders, were stable at £488 million compared with £486 million in 2005.

2005 compared with 2004

Total income for 2005 of £7,442 million and contribution of £3,781 million were adversely affected by the implementation of IAS 32, IAS 39 and IFRS 4 on 1 January 2005. Operating profit before tax fell by 16% to £2,264 million.

During 2005 we continued to demonstrate our commitment to customer service, with significant progress in terms of the proportion of our customers who are extremely satisfied and we are making pleasing progress in the current account switcher market. Among the high street banks, Royal Bank of Scotland ranks first for customer satisfaction with NatWest in joint second place.

Against the backdrop of a slower rate of growth in consumer borrowing, we have delivered robust business growth in average loans and advances, especially mortgage lending with particularly good growth in higher margin products such as the offset mortgage. Average unsecured personal lending, where we took further steps to enhance our focus on high quality new business, was also up. Average customer deposits grew, with particularly good inflows into savings products.

Net interest income increased by 5%, or £210 million, to £4,068 million. This increase reflects, amongst other things, the success of the First Active brand in the UK mortgage market and the maturing of the MINT portfolio. Net interest margin was lower in 2005 than in 2004 with increased product margins offsetting mix effects. Spreads in mortgages and some savings products improved in the latter part of the year.

Non-interest income fell by 4% to £3,374 million. Growth in income from core personal and small business banking services, good progress in our private banking and investment businesses, higher volumes in both domestic and international card acquiring, strong sales through Tesco Personal Finance, the introduction of balance transfer fees and good growth in Europe were offset by the effect of IAS 39 and IFRS 4 on recognition of fee income and bancassurance income.

Direct expense grew by 5%, partly due to investment in future income initiatives in the second half of the year. Staff costs increased by 9% to £1,307 million primarily as a result of continued investment in customer-facing staff with over 500 additional customer advisors in branches, an increase in telephone banking advisors, and continued expansion of our bancassurance and investment businesses. We continue to make efficiency gains in other areas contributing to a decrease in other costs to £696 million. A more cautious approach to direct lending along with our successful focus on recruitment of customers through branches also contributed to this decrease.

Net claims in bancassurance, which under IFRS include maturities, surrenders and liabilities to policyholders, were £486 million compared with £702 million in 2004.

Impairment losses increased by 67% or £470 million to £1,172 million. The increased charge principally reflects the implementation of IAS 39 from 1 January 2005, growth in lending and increase in personal arrears over recent years. We have taken further steps to refine our credit policy, tighten lending criteria and improve our recoveries process.

Operating and financial review continued

Wealth Management

	2006 £m	2005 £m	2004 £m
Net interest income	500	442	403
Non-interest income	434	372	370
Total income	934	814	773
Direct expenses			
staff costs	299	258	262
other	137	133	134
	436	391	396
Impairment losses	1	13	18
Contribution	497	410	359
Allocation of Manufacturing costs	143	138	128
Operating profit before tax	354	272	231

	31 December 2006 £bn	31 December 2005 £bn	1 January 2005 £bn
Loans and advances to customers gross	8.8	7.8	7.1
Investment management assets excluding deposits	28.2	25.4	21.6
Customer deposits	28.5	25.5	22.3
Risk-weighted assets	6.5	6.1	6.0

2006 compared with 2005

Wealth Management delivered strong growth, with total income rising by 15% to £934 million. Contribution grew by 21% to £497 million and operating profit before tax by 30% to £354 million.

Wealth Managements offering of private banking and investment services delivered robust organic income growth in 2006. Our continuing investment in Coutts UK, Adam & Company and our offshore businesses helped us to achieve an overall increase in client numbers of 5%. Coutts UK customers rose by 9%. Outside the UK, Coutts International moved its headquarters to Singapore and was successful in the Asia-Pacific region in recruiting additional experienced private bankers. We grew customer numbers in the region by 13% and income by 24%.

Growth in banking volumes contributed to a 13% rise in net interest income to £500 million. Average loans and advances to customers rose by 14% and average deposits by 10%, with net interest margin maintained at close to 2005 levels.

Non-interest income grew by 17% to £434 million, reflecting higher investment management fees and performance fees, as well as strong growth in new business volumes, particularly in the UK. Assets under management rose by 11%, to £28.2 billion at the year-end.

Total expenses rose by 9% to £579 million. In a highly competitive recruitment market, headcount was successfully increased by 7%, reflecting our continued investment in the UK and further expansion in Asia.

Impairment losses returned to historic levels, following a number of specific items in prior years.

2005 compared with 2004

Total income rose by 5% to £814 million, reflecting good growth across all our businesses, and contribution was 14% higher at £410 million. Operating profit before tax rose by 18% to £272 million. Coutts UK and Adam & Co both gained good numbers of customers, with Coutts up 7% and Adam up 11%. 2005 also saw the continuation of rapid growth in Asia, where the number of private bankers increased by 20%, with particular emphasis placed on recruitment for the Chinese and Indian markets.

Net interest income increased by 10% to £442 million. Strong growth in average customer loans and deposits was partially offset by lower net interest margin due to a change in the mix of business.

Non-interest income was steady at £372 million. Average assets under management rose 9% to £23.1 billion as a result of good new business volumes in Coutts UK and the rise in equity markets. Assets under management at the year end were £25.4 billion, an increase of 18%.

Direct expenses decreased by 1% to £391 million, reflecting a continued focus on efficiency. Despite continued investment in growth markets in both the UK and overseas, staff costs were 2% lower than in 2004. Other costs reduced to £133 million.

Impairment losses amounted to £13 million, down £5 million.

Ulster Bank

	2006 £m	2005 £m	2004 £m
Net interest income	773	655	550
Non-interest income	215	203	193
Total income	988	858	743
Direct expenses			
staff costs	224	191	172
other	91	79	79
	315	270	251
Impairment losses	71	58	40
Contribution	602	530	452
Allocation of Manufacturing costs	214	207	192
Operating profit before tax	388	323	260

	31 December 2006 £bn	31 December 2005 £bn	1 January 2005 £bn
Total assets	43.1	35.9	28.7
Loans and advances to customers gross			
mortgages	15.0	13.2	10.1
corporate	19.6	13.7	12.2
other	2.1	1.3	0.7
Customer deposits	18.0	15.9	13.6
Risk-weighted assets	28.3	22.4	18.6
Average exchange rate /£	1.467	1.463	1.474
Spot exchange rate /£	1.490	1.457	1.418

2006 compared with 2005

Ulster Bank made strong progress in both personal and corporate banking in the Republic of Ireland and in Northern Ireland, with total income rising by 15% to £988 million. Contribution increased by 14% to £602 million and operating profit before tax by 20% to £388 million.

Net interest income increased by 18% to £773 million, reflecting growth in both loans and customer deposits. Average loans and advances to customers increased by 28%, and average customer deposits by 15%. A principal focus during 2006 was the expansion of our corporate banking franchise, and we succeeded in increasing corporate customer numbers by 7% in the Republic of Ireland and by 4% in Northern Ireland. This contributed to strong growth in both corporate lending, where average loans and advances increased by 32%, and deposits, with Ulster Bank winning a share of new business current accounts well in excess of its historic market share, particularly in the Republic of Ireland. Average mortgage balances grew by 26%, although the rate of growth was slower in the second half when there was some evidence of a more subdued pace of expansion in the mortgage market. The change in business mix resulting from strong growth in corporate lending and mortgages, together with some competitive pressures, led to a modest reduction in net interest margin in the first half, with margin stabilising in the second half.

Non-interest income rose by 6% to £215 million. Ulster Bank achieved good growth in fees from credit cards and ATMs as well as in sales of investment products, which was only partially offset by the introduction of Ulster Bank□s new range of current accounts, which are free of transaction fees.

Total expenses increased by 11% to £529 million, as we continued our investment programme to support the future growth of the business. We recruited additional customer-facing staff, particularly in corporate banking, opened three new business centres and continued with our branch improvement programme. By the end of 2006, 70% of Ulster Bank branches had been upgraded.

During 2006 we successfully completed the migration of our core systems to the RBS Group manufacturing model and, as a result, we now have access to the complete RBS product range.

The credit environment remains benign. Impairment losses rose by £13 million to £71 million, consistent with growth in lending.

2005 compared with 2004

Total income increased by 15% to £858 million, with contribution up 17% to £530 million, as Ulster Bank achieved another year of strong growth, with excellent customer recruitment, robust lending volumes and very good growth in deposits. First Active continues to perform well and in line with our integration plan. It led the Republic of Ireland market with the introduction of new mortgage products, as well as launching new credit card and direct loan products. Operating profit before tax rose by 24% to £323 million.

The number of personal and business customers increased by 68,000 in the year. Ulster Bank personal customer numbers rose by 9% in the Republic of Ireland, where our switcher mortgage product has helped us to gain market share. In Northern Ireland, Ulster Bank significantly enhanced its personal current account offering in the fourth quarter to provide free banking to all customers.

Net interest income rose by 19% to £655 million. Average loans and advances and average customer deposits both grew strongly. However, the continuing strong growth in mortgages and business loans led to a decline in net interest margin.

Direct expenses increased by 8% to £270 million, as a result of investment to support the growth of the business. This investment will continue into 2006. We have continued with our branch improvement programme, upgrading 50 branches in the Republic of Ireland and 39 in Northern Ireland.

Impairment losses increased by £18 million to £58 million, reflecting the growth in lending.

Operating and financial review continued

Citizens

	2006 £m	2005 £m	2004 £m	2006 US$m	2005 US$m	2004 US$m
Net interest income	2,085	2,122	1,609	3,844	3,861	2,948
Non-interest income	1,232	1,142	659	2,271	2,079	1,207
Total income	3,317	3,264	2,268	6,115	5,940	4,155
Direct expenses						
staff costs	803	819	580	1,480	1,490	1,063
other	751	739	500	1,385	1,344	916
	1,554	1,558	1,080	2,865	2,834	1,979
Impairment losses	181	131	117	333	239	214
Operating profit before tax	1,582	1,575	1,071	2,917	2,867	1,962

	31 December 2006 £bn	31 December 2005 £bn	1 January 2005 £bn	31 December 2006 US$bn	31 December 2005 US$bn	1 January 2005 US$bn
Total assets	82.6	92.2	73.2	162.2	158.8	141.7
Loans and advances to customers gross						
mortgages	9.5	10.9	7.5	18.6	18.8	14.4
home equity	17.6	18.5	14.1	34.5	31.8	27.2
other consumer	11.7	14.4	10.9	23.2	24.8	21.2
corporate and commercial	16.7	17.0	14.9	32.7	29.2	28.9
Customer deposits	54.3	61.7	51.3	106.8	106.3	99.2
Risk-weighted assets	57.6	61.8	48.3	113.1	106.4	93.5
Average exchange rate US$/£				1.844	1.820	1.832
Spot exchange rate US$/£				1.965	1.721	1.935

2006 compared with 2005

Citizens grew its total income by 2% to £3,317 million, while its operating profit rose slightly to £1,582 million. In dollar terms, Citizens total income increased by 3% to $6,115 million and its operating profit before tax by 2% to $2,917 million.

We have achieved good growth in lending volumes, with average loans and advances to customers increasing by 10%. In business lending, average loans excluding finance leases increased by 15%, reflecting Citizens success in adding new mid-corporate customers and increasing its total number of business customers by 4% to 467,000. In personal lending, Citizens increased average mortgage and home equity lending by 14%, though the mortgage market slowed in the second half. Average credit card receivables, while still relatively small, increased by 19%.

We increased average customer deposits by 4%, although spot balances at the end of 2006 were little changed from the end of 2005. As interest rates rose further and the US yield curve inverted, we saw migration from low-cost checking and liquid savings to higher-cost term and time deposits. This migration is a principal reason for the decline in Citizens net interest margin to 2.72% in 2006, compared with 3.00% in 2005. The decline slowed over the course of the year, with net interest margin in the second half 6 basis points lower than in the first. Lower net interest margins more than offset the benefit of higher average loans and deposits, leaving net interest income marginally lower at $3,844 million.

Non-interest income rose by 8% to £1,232 million. In dollar terms, non-interest income rose by 9% to $2,271 million. Business and corporate fees rose strongly, with good results especially in foreign exchange, interest rate derivatives and cash management benefiting from increased activity with Corporate Markets. There was good progress in debit cards, where issuance has been boosted by the launch in September of our "Everyday Rewards" programme. Citizens has also become the USs leading issuer of Paypass contactless debit cards, with 3.65 million cards issued. Our credit card customers increased by 20%, whilst RBS Lynk, our merchant acquiring business, also achieved significant growth, processing 40% more transactions than it did in 2005 and expanding its merchant base by 11%.

Total expenses were flat, reflecting tight cost control and a 5% reduction in headcount, despite continued investment in growth opportunities such as mid-corporate banking, contactless debit cards, merchant acquiring and supermarket banking.

Citizens continued to expand its branch network. Our partnership with Stop & Shop Supermarkets has helped us to expand our supermarket banking franchise into New York, while in October we announced the purchase of GreatBanc, Inc., strengthening our position in the Chicago market and making us the 4th largest bank in the Chicago area, based on deposits. The acquisition was completed in February 2007.

Impairment losses totalled £181 million ($333 million), representing just 0.31% of loans and advances to customers and illustrating the prime quality of our portfolio. Underlying strong credit quality remained unchanged as our portfolio grew, with risk elements in lending and problem loans representing 0.32% of loans and advances, the same level as in 2005. Our consumer lending is to prime customers with average FICO scores on our portfolios, including home equity lines of credit, in excess of 700, and 95% of lending is secured.

2005 compared with 2004

Citizens performed well in 2005, delivering a strong underlying performance in challenging market conditions both from the old Citizens franchise and from Charter One. Total income grew by 44% to £3,264 million and contribution by 47% to £1,575 million. Total income, in US dollars, rose by 43% to $5,940 million and contribution by 46% to $2,867 million, including a full year's contribution from Charter One. Excluding Charter One and other acquisitions, income rose by 7% and contribution by 10%, despite the impact of the flattening of the yield curve, which reduced net interest margin and the rate of growth in net interest income.

We have grown our customer numbers in both personal and business segments, with Charter One increasing its small business and corporate customer base by 10%. Cooperation between Citizens and RBS Global Banking & Markets and UK Corporate Banking is yielding good results. Citizens' new international cash management service has already won nearly 300 new accounts with existing RBS customers, bringing in more than $80 million of new core deposits.

Our cards businesses, which are only active in the prime and superprime segments, have made good progress. Credit card balances increased by 19% to $2.5 billion, as RBS National launched into a number of new channels such as Charter One branches. RBS Lynk, our merchant acquiring business, increased its customer base by 24%.

The integration of Charter One progressed well and all phases of the IT conversion were completed in July 2005, five months ahead of schedule. This involved the conversion to Citizens' systems of over 750 branches and three million customer accounts spread over a wide geography. Despite the focus on the integration process, Charter One achieved good growth in business volumes, with loans and advances up 18% over the course of the year and customers deposits up 10%.

Net interest income increased by 32% to £2,122 million. In dollar terms, net interest income increased by 31% to $3,861 million. This reflected strong growth in both lending and deposits. Excluding acquisitions, average lending increased by 13% or $6.7 billion, with robust growth in secured consumer lending, and average customer deposits by 9% or $5.7 billion. However, as a consequence of the flattening yield curve, net interest income excluding acquisitions was only 4% higher at $2,534 million.

Non-interest income was up 73% to £1,142 million. In dollar terms, non-interest income was up 72% to $2,079 million. Excluding acquisitions, non-interest income grew by 15% to $1,004 million, benefiting from higher fee income, increased student loan and leasing activities, and investment gains.

Direct expenses were up 44% to £1,558 million. In dollar terms, direct expenses were up 43% to $2,834 million. Expense growth, excluding acquisitions, was contained to 6%.

Impairment losses were up £14 million to £131 million. In dollar terms, impairment losses, including acquisitions, were up $25 million to $239 million. Credit quality overall remained stable. More than 90% of our personal sector lending is secured, and as a result there was minimal impact from the change in US bankruptcy laws in 2005.

RBS Insurance

	2006 £m	2005 £m	2004 £m
Earned premiums	5,713	5,641	5,507
Reinsurers share	(212)	(246)	(454)
Insurance premium income	5,501	5,395	5,053
Net fees and commissions	(486)	(449)	(481)
Other income	664	543	467
Total income	5,679	5,489	5,039
Direct expenses			
staff costs	319	316	295
other	426	411	313
	745	727	608
Gross claims	4,030	3,903	3,826
Reinsurers share	(60)	(76)	(268)
Net claims	3,970	3,827	3,558
Contribution	964	935	873
Allocation of Manufacturing costs	214	207	192
Operating profit before tax	750	728	681

	31 December 2006	31 December 2005	31 December 2004
In-force policies (000s)			
Core motor: UK	7,490	7,439	7,174
Core motor: Continental Europe	2,114	1,862	1,639
Core non-motor (including home, rescue, SMEs, pet, HR24): UK	4,920	4,799	4,450
Partnerships (including motor, home, rescue, SMEs, pet, HR24)	7,267	7,559	7,370
General insurance reserves total (£m)	8,068	7,776	7,379

2006 compared with 2005

RBS Insurance increased total income by 3% to £5,679 million, with contribution also rising by 3% to £964 million and operating profit before tax by the same percentage to £750 million.

We achieved good overall policy growth of 3% in our core businesses including excellent progress in our European businesses. Our joint venture in Spain grew policy numbers by 14% to 1.34 million.

In the UK we have grown our core motor book by 1% whilst focusing on more profitable customers acquired through our direct brands, with good results achieved through the internet channel, which accounted for half of all new own-brand motor policies last year.

We implemented price rises in motor insurance in the second half of the year, and average motor premium rates across the market increased in the fourth quarter. Higher premium rates will, however, take time to feed through into income, and competition on prices remains strong.

Our core non-motor personal lines policies grew by 3%, with particularly good progress in Tesco Personal Finance. SME has also performed well with policies sold through our intermediary business growing by 10%.

However, some of our partnership books continue to age and we did not renew a number of other partnerships. As a result, the number of partnership policies in force fell by 8% in motor and by 9% in home.

Insurance premium income was up 2% to £5,501 million, reflecting a modest overall increase in the total number of in-force policies.

Net fees and commissions payable increased by 8% to £486 million, whilst other income rose by 22% to £664 million, reflecting increased investment income.

Total expenses rose by 3% to £959 million. Good cost discipline held direct expenses to £745 million, up 2%. Staff costs rose by 1%, reflecting improved efficiency despite continued investment in service standards. A 4% rise in non-staff costs included increased marketing expenditure to support growth in continental Europe.

Net claims rose by 4% to £3,970 million. The environment for home claims remained benign, whilst underlying increases in average motor claims costs were partially offset by purchasing efficiencies and improvements in risk management.

The UK combined operating ratio for 2006, including Manufacturing costs, was 94.6%, compared with 93.4% in 2005, reflecting a higher loss ratio and the discontinuation of some partnerships.

2005 compared with 2004

RBS Insurance produced a good performance in 2005, with total income increasing by 9% to £5,489 million and contribution by 7% to £935 million. Operating profit before tax rose by 7% to £728 million. The integration of Churchill was completed in September 2005, ahead of plan, and Churchill delivered greater transaction benefits than anticipated at the time of the acquisition. Following the integration of Churchill, all our direct general insurance businesses in the UK now operate on a common platform.

RBS Insurance achieved 4% growth in UK motor policies in force. In achieving this against a background of very strong competition in UK motor insurance, we benefited from the strength of our brands and the diversity of our distribution channels. Growth came through our direct brands, through our partnership business, where we operate insurance schemes on behalf of third parties who in turn sell insurance products to their customers, and through NIG, our intermediary business acquired as part of Churchill. Our businesses in Spain, Germany and Italy together delivered 14% growth in motor policies in force. Linea Directa, our joint venture with Bankinter, increased its customer base by 17% and, with more than 1 million policies, is the largest direct motor insurer and sixth largest motor insurer in Spain.

Total home insurance policies declined by 1%. Within this total, we continued to expand through our direct brands but there was attrition of some partner-branded books.

In addition to expanding its intermediary business in motor and home insurance, NIG achieved 10% growth in commercial policies sold to SMEs.

Direct expenses rose by 20%. Excluding the impact of a change in reinsurance arrangements, total income rose by 6% and expenses by 9%. Net insurance claims on the same basis were up by 5%, reflecting increased volumes, claims inflation in motor and an increase in home claims following severe storms in the UK in January 2005.

The UK combined operating ratio for 2005 was 93.4%.

Operating and financial review continued

Manufacturing

	2006 £m	2005 £m	2004 £m
Staff costs	763	725	757
Other costs	2,089	2,033	1,795
Total Manufacturing costs	2,852	2,758	2,552
Allocated to divisions	(2,852)	(2,758)	(2,552)
Analysis of Manufacturing costs:			
Group Technology	966	953	860
Group Property	910	834	733
Customer Support and other operations	976	971	959
Total Manufacturing costs	2,852	2,758	2,552

2006 compared with 2005

Manufacturing costs increased by 3% to £2,852 million, benefiting from investment in efficiency programmes while supporting business growth and maintaining high levels of customer satisfaction. Staff costs rose by 5%, with increases in Group Technology partially offset by reduced headcount in Operations.

Group Technology costs were 1% higher at £966 million, as we achieved significant improvements in productivity balanced by investment in software development. In the biggest integration project undertaken since NatWest, we brought Ulster Bank onto the RBS technology platform.

Group Property costs increased by 9% to £910 million, reflecting the continuation of our branch improvement programme and ongoing investment in major operational centres, including Manchester, Birmingham and Glasgow.

Customer Support and other operations held costs virtually flat at £976 million and, like Group Technology, achieved significant improvements in productivity. At the same time we maintained our focus on service quality, and our UK-based telephony centres continued to record market-leading customer satisfaction scores. Our investment in lean manufacturing approaches across our operational centres is expected to deliver further improvements in efficiency.

2005 compared with 2004

Manufacturing s costs increased by 8% to £2,758 million. Excluding software amortisation, costs rose by 4%. Costs relating to internal software development, which under UK GAAP were written off as incurred, are now under IFRS capitalised and amortised.

Group Technology costs increased by 11% to £953 million. Excluding software amortisation, costs were up 2%, with support for increased business volumes offset by efficiency improvements. The Group Efficiency Programme was substantially completed during the year, with major implementations such as a new system for handling customer queries and a new customer account-opening platform. The Churchill systems integration was completed in September 2005.

Group Property costs increased by 14% to £834 million. We improved the efficiency of our property utilisation in 2005 while continuing our programme of investment both in the branch networks and in our major operational centres, including Birmingham, Manchester and our new headquarters in Edinburgh.

Customer Support and other operations costs increased by 1% to £971 million despite a much greater increase in the business volumes supported. Cash withdrawals from ATMs, for example, rose by 13%, while we handled 10% more mortgage applications and 7% more personal loan volumes. These increases were absorbed by improved efficiency through the delivery of new systems and ways of working.

Central items

	2006 £m	2005 £m	2004 £m
Funding costs	780	801	245
Departmental and corporate costs	588	586	367
	1,368	1,387	612
Allocation of Manufacturing costs	143	137	127
Total central Items	1,511	1,524	739

2006 compared with 2005

Total central items decreased by 1% to £1,511 million.

Central funding costs were 3% lower at £780 million, largely reflecting a year on year reduction of £41 million in IFRS-related volatility. The Group hedges its economic risks, and volatility attributable to derivatives in economic hedges that do not meet the criteria in IFRS for hedge accounting is transferred to the Group□s central treasury function.

Departmental and corporate costs at £588 million were similar to 2005.

2005 compared with 2004

Total central items increased by £775 million to £1,387 million, before allocation of Manufacturing costs and by £785 million to £1,524 million after allocation of Manufacturing costs.

Funding costs at £801 million, were up £556 million largely because of the full year funding cost of the acquisition of Charter One in August 2004 and the effect of implementing IAS 32 (reclassification of funding costs on preference shares and trust preferred securities from dividends payable and minority interests respectively to interest payable). The Group□s primary objective is to hedge its economic risks. So as not to distort divisional results, volatility attributable to derivatives in economic hedges that do not meet the criteria in IFRS for hedge accounting is transferred to the Group□s central treasury function. This resulted in a charge of £45 million, in addition to a charge for £14 million for hedge ineffectiveness under IFRS.

Central departmental costs and other corporate items at £586 million were £219 million higher than 2004. This was principally due to higher pension costs and the centralisation of certain functions, and includes ongoing expenditure on regulatory projects such as Basel II and Sarbanes-Oxley Section 404.

Operating and financial review continued

Employee numbers at 31 December (full time equivalents rounded to the nearest hundred)

	2006	2005	2004
Global Banking & Markets	8,700	7,400	8,900
UK Corporate Banking	8,800	8,400	7,900
Retail	39,800	40,400	39,200
Wealth Management	4,500	4,200	4,100
Ulster Bank	4,800	4,400	4,100
Citizens	23,100	24,400	24,000
RBS Insurance	17,500	19,300	19,400
Manufacturing	25,200	26,000	26,900
Centre	2,600	2,500	2,100
Group total	135,000	137,000	136,600

2006 compared with 2005

The number of employees at 31 December 2006 was 135,000, a decrease of 2,000 compared with the prior year.

2005 compared with 2004

The number of employees increased by 400 to 137,000 with increases in Retail Banking, Citizens and Ulster Bank partially offset by a reduction in Global Banking & Markets and UK Corporate Banking.

Consolidated balance sheet
at 31 December 2006

	2006 £m	2005 £m
Assets		
Cash and balances at central banks	6,121	4,759
Treasury and other eligible bills	5,491	5,538
Loans and advances to banks	82,606	70,587
Loans and advances to customers	466,893	417,226
Debt securities	127,251	120,965
Equity shares	13,504	9,301
Intangible assets	18,904	19,932
Property, plant and equipment	18,420	18,053
Settlement balances	7,425	6,005
Derivatives	116,681	95,663
Prepayments, accrued income and other assets	8,136	8,798
Total assets	871,432	776,827
Liabilities		
Deposits by banks	132,143	110,407
Customer accounts	384,222	342,867
Debt securities in issue	85,963	90,420
Settlement balances and short positions	49,476	43,988
Derivatives	118,112	96,438
Accruals, deferred income and other liabilities	15,660	14,247
Retirement benefit liabilities	1,992	3,735
Deferred taxation	3,264	1,695
Insurance liabilities	7,456	7,212
Subordinated liabilities	27,654	28,274
Total liabilities	825,942	739,283
Equity		
Minority interests	5,263	2,109
Shareholders equity		
Called up share capital	815	826
Reserves	39,412	34,609
Total equity	45,490	37,544
Total liabilities and equity	871,432	776,827

Analysis of repurchase agreements included above

Reverse repurchase agreements and stock borrowing		
Loans and advances to banks	54,152	41,804
Loans and advances to customers	62,908	48,887
	117,060	90,691
Repurchase agreements and stock lending		
Deposits by banks	76,376	47,905
Customer accounts	63,984	48,754
	140,360	96,659

Operating and financial review continued

Overview of consolidated balance sheet

Total assets of £871.4 billion at 31 December 2006 were up £94.6 billion, 12%, compared with 31 December 2005, reflecting business growth.

Treasury and other eligible bills remained stable at £5.5 billion.

Loans and advances to banks increased by £12.0 billion, 17%, to £82.6 billion. Reverse repurchase agreements and stock borrowing ("reverse repos") increased by £12.3 billion, 30% to £54.2 billion, offset by a reduction in bank placings of £0.3 billion, 1% to £28.4 billion.

Loans and advances to customers were up £49.7 billion, 12%, to £466.9 billion. Within this, reverse repos increased by 29%, £14.0 billion to £62.9 billion. Excluding reverse repos, lending rose by £35.7 billion, 10%, to £404.0 billion reflecting organic growth across all divisions.

Debt securities increased by £6.3 billion, 5%, to £127.3 billion, principally due to increased trading book holdings in Corporate Markets.

Equity shares rose by £4.2 billion, 45%, to £13.5 billion, reflecting the increase in the fair value of available-for-sale securities, principally the investment in Bank of China.

Intangible assets decreased by £1.0 billion, 5%, to £18.9 billion, principally due to exchange rate movements.

Property, plant and equipment were up £0.4 billion, 2%, to £18.4 billion, mainly due to growth in investment properties and operating lease assets.

Settlement balances rose £1.4 billion, 24%, to £7.4 billion as a result of increased customer activity.

Derivatives, assets and liabilities, increased reflecting growth in trading volumes and the effects of interest and exchange rates.

Prepayments, accrued income and other assets were down £0.7 billion, 8%, to £8.1 billion.

Deposits by banks rose by £21.7 billion, 20%, to £132.1 billion to fund business growth. Increased repurchase agreements and stock lending ("repos"), up £28.5 billion, 59%, to £76.4 billion were partially offset by lower inter-bank deposits, down £6.8 billion, 11%, at £55.7 billion.

Customer accounts were up £41.4 billion, 12%, at £384.2 billion. Within this, repos increased £15.3 billion, 31%, to £64.0 billion. Excluding repos, deposits rose by £26.1 billion, 9%, to £320.2 billion with good growth in all divisions.

Debt securities in issue decreased by £4.5 billion, 5%, to £86.0 billion.

The increase in settlement balances and short positions, up £5.5 billion, 12%, to £49.5 billion, reflected growth in customer activity.

Accruals, deferred income and other liabilities increased £1.4 billion, 10%, to £15.7 billion.

Subordinated liabilities were down £0.6 billion, 2%, to £27.7 billion. The issue of £2.3 billion dated and £0.7 billion undated loan capital was offset by the redemption of £0.3 billion dated loan capital, £0.7 billion undated loan capital and £0.3 billion non-cumulative preference shares and the effect of exchange rates, £1.7 billion and other movements, £0.6 billion.

Deferred taxation liabilities rose by £1.6 billion to £3.3 billion largely reflecting the provision for tax on the uplift in the value of available-for-sale equity shares.

Equity minority interests increased by £3.2 billion to £5.3 billion. Of the increase, £2.1 billion related to the uplift in the value of the investment in Bank of China attributable to minority shareholders. The remaining increase primarily arose from the issue of £400 million trust preferred securities and a restructuring of the life assurance joint venture with Aviva, following the repayment of an existing loan replaced by an equity investment. This restructuring has no effect on the Groups regulatory capital position.

Shareholders equity increased by £4.8 billion, 14%, to £40.2 billion. The profit for the year of £6.4 billion, issue of £0.7 billion non-cumulative fixed rate equity preference shares and £0.1 billion of ordinary shares in respect of the exercise of share options, £1.6 billion increase in available-for-sale reserves, mainly reflecting the Groups share in the investment in Bank of China and a £1.3 billion net decrease after tax in the Groups pension liability, were partly offset by the payment of the 2005 final ordinary dividend and the 2006 interim dividend, £2.5 billion and preference dividends of £0.2 billion, together with £1.0 billion ordinary share buybacks and £1.6 billion resulting from the effect of exchange rates and other movements.

Cash flow

	2006 £m	2005* £m	2004* £m
Net cash flows from operating activities	17,441	4,140	5,099
Net cash flows from investing activities	6,645	(2,612)	(9,398)
Net cash flows from financing activities	(1,516)	(703)	7,119
Effects of exchange rate changes on cash and cash equivalents	(3,468)	1,703	(920)
Net increase in cash and cash equivalents	19,102	2,528	1,900

* restated (see Note 48)

2006

The major factors contributing to the net cash inflow from operating activities of £17,441 million were the profit before tax of £9,186 million adjusted for the elimination of foreign exchange differences of £4,516 million and depreciation and amortisation of £1,678 million, together with an increase of £3,980 million in operating liabilities less operating assets.

Net sales and maturities of securities of £8,000 million was partially offset by net purchases of property, plant and equipment of £1,292 million, resulting in the net cash inflow from investing activities of £6,645 million.

The issue of £671 million of equity preference shares, £3,027 million of subordinated liabilities and proceeds of £1,354 million from minority interests issued were more than offset by dividend payments of £2,727 million, purchase of ordinary shares amounting to £991 million, repayment of £1,318 million of subordinated liabilities and interest on subordinated liabilities of £1,409 million, resulting in a net cash outflow from financing activities of £1,516 million.

2005

The major factors contributing to the net cash inflow of £4,140 million from operating activities in 2005 were the profit before tax of £7,936 million less elimination of foreign exchange differences of £3,060 million, increases in deposits and debt securities in issue of £56,571 million, and increases in short positions and settlement balances of £10,326 million, partially offset by increases in securities of £28,842 million and increases in loans and advances of £36,778 million.

Net purchases of property, plant and equipment of £2,592 million, including operating lease assets and computer and other equipment, were the main contributors to the net cash outflow from investing activities of £2,612 million.

The issue of £1,649 million preference shares and £1,234 million subordinated debt were more than offset by dividend payments of £2,007 million and the repayment of £1,553 million of subordinated liabilities, resulting in a net cash outflow from financing activities of £703 million.

2004

The major factors contributing to the net cash inflow of £5,099 million from operating activities in 2004 were the profit before tax of £7,284 million, increases in deposits and debt securities in issue of £72,146 million, and in short positions and settlement balances of £8,796 million, partially offset by increases in securities of £11,883 million and in loans and advances of £72,955 million.

Net purchases of fixed assets, including operating lease assets and computer and other equipment, of £2,662 million and net investment in business interests and intangible assets of £7,968 million led to the net cash outflow from investing activities of £9,398 million.

The issue of £1,358 million preference shares and £2,845 million ordinary shares, and £4,624 million subordinated liabilities, partly offset by the payment of £1,635 million of dividends, were the main contributors to the net cash inflow from financing activities of £7,119 million.

Operating and financial review continued

IFRS compared with US GAAP

The Groups financial statements are prepared in accordance with IFRS, which differ in certain material respects from US GAAP as described on pages 176 to 186.

The net income available for ordinary shareholders under US GAAP was £5,440 million; £762 million lower than profit attributable to ordinary shareholders under IFRS of £6,202 million. The principal reasons for the decrease are:

- reversal of net revaluation gains of £470 million on investment properties.
- reduction of £454 million from eliminating IFRS hedge accounting adjustments partially offset by an increase of £196 million relating to financial instruments, principally net foreign exchange losses on available-for-sale securities.
- higher pension costs of £387 million under US GAAP reflecting the deferral of actuarial losses over the remaining service lives of current employees.
- tax of £410 million on the above and other adjustments.

US GAAP shareholders equity at £40,077 million is £150 million lower than IFRS shareholders equity of £40,227 million mainly attributable to the reversal of revaluation gains: £2,558 million on financial instruments, principally the Groups investment in Bank of China and £873 million on investment and own-use properties, offset by the inclusion of £1,491 million of preference shares classified as debt under IFRS, an increase of £520 million from the deferral and amortisation of loan origination costs, net difference of £692 million on acquisition accounting and intangibles and tax on these and other adjustments of £784 million.

Capital resources

Upon adoption of IFRS by listed banks in the UK on 1 January 2005, the Financial Services Authority ("FSA") changed its regulatory requirements such that the measurement of capital adequacy was based on IFRS subject to a number of prudential filters. The data as at 31 December 2006 and 2005 set out below has been presented in compliance with these revised FSA requirements.

	2006-IFRS £m	2005-IFRS £m
Capital base		
Tier 1 capital	30,041	28,218
Tier 2 capital	27,491	22,437
	57,532	50,655
Less: investments in insurance subsidiaries, associated undertakings and other supervisory deductions	(10,583)	(7,282)
Total capital	46,949	43,373

Risk-weighted assets		
Banking book:		
On-balance sheet	318,600	303,300
Off-balance sheet	59,400	51,500
Trading book	22,300	16,200
	400,300	371,000
Risk asset ratios	%	%
Tier 1	7.5	7.6
Total	11.7	11.7

The data set forth below are in accordance with FSA regulations at the time and are based on UK GAAP.

	2004-UK GAAP £m	2003-UK GAAP £m	2002-UK GAAP £m
Capital base			
Tier 1 capital	22,694	19,399	17,155
Tier 2 capital	20,229	16,439	13,271
	42,923	35,838	30,426
Less: investments in insurance subsidiaries, associated undertakings and other supervisory deductions	(5,165)	(4,618)	(3,146)
Total capital	37,758	31,220	27,280
Risk-weighted assets			
Banking book:			
On-balance sheet	261,800	214,400	193,800
Off-balance sheet	44,900	36,400	28,700
Trading book	17,100	12,900	11,500
	323,800	263,700	234,000
Risk asset ratios	%	%	%
Tier 1	7.0	7.4	7.3
Total	11.7	11.8	11.7

It is the Group's policy to maintain a strong capital base, to expand it as appropriate and to utilise it efficiently throughout its activities to optimise the return to shareholders while maintaining a prudent relationship between the capital base and the underlying risks of the business. In carrying out this policy, the Group has regard to the supervisory requirements of the Financial Services Authority ("FSA"). The FSA uses Risk Asset Ratio ("RAR") as a measure of capital adequacy in the UK banking sector, comparing a bank's capital resources with its risk-weighted assets (the assets and off-balance sheet exposures are "weighted" to reflect the inherent credit and other risks); by international agreement, the RAR should be not less than 8% with a tier 1 component of not less than 4%. At 31 December 2006, the Group's total RAR was 11.7% (2005 – 11.7%) and the tier 1 RAR was 7.5% (2005 – 7.6%).

Risk management

Governance framework

The Board sets the overall risk appetite and philosophy for the Group. Various Board and executive sub-committees support these goals, as follows:

- **Group Audit Committee** (GAC) is a committee comprising independent non-executive directors that supports the Board in carrying out its responsibilities for financial reporting including accounting policies and in respect of internal control and risk assessment. The Group Audit Committee monitors the ongoing process of the identification, evaluation and management of all significant risks throughout the Group. The Committee is supported by Group Internal Audit which provides an independent assessment of the design, adequacy and effectiveness of the Groups internal controls.

- **Advances Committee** is a board committee that deals with all transactions that exceed the Group Credit Committees delegated authority.

In addition to the responsibilities at Board level, operational authority and oversight is delegated to the Group Executive Management Committee (GEMC), which is responsible for implementing a risk management framework consistent with the Boards risk appetite. The GEMC, in turn, is supported by the following committees:

- **Group Risk Committee** (GRC) is an executive risk governance committee which recommends and approves limits, processes and policies in respect of the effective management of all material non-balance sheet risks across the Group.

- **Group Credit Committee** (GCC) is responsible for approving credit proposals under authority delegated to it by the Board. Credit proposals exceeding the authority of GCC are referred to the Advances Committee. The GCC in turn delegates authority to divisional credit committees.

- **Group Asset and Liability Management Committee** (GALCO), is an executive committee which is responsible for reviewing the balance sheet, funding, liquidity, structural foreign exchange, capital adequacy and capital raising across the Group as well as interest rate risk in the banking book. In addition, GALCO monitors and reviews external, economic and environmental changes affecting such risks.

These Committees are supported by Group Internal Audit and also by two dedicated group level functions, Group Risk Management (GRM), which has responsibility for credit, market, regulatory and enterprise risk and Group Treasury which is responsible for the management of the Groups balance sheet, capital raising, intra group credit exposure, liquidity and hedging policies. Both functions report to GEMC and the Group Board through the Group Finance Director and play an active role in assessing and monitoring the effectiveness of the divisional risk management functions.

Heads of Group Risk Management and Internal Audit have direct access to the Group Chief Executive and the Chairman of the Group Audit Committee.

Operating and financial review continued

Risk management

The principal risks that the Group manages are as follows:

- **Credit risk**: is the risk arising from the possibility that the Group will incur losses from the failure of customers to meet their obligations.
- **Liquidity risk**: is the risk that the Group is unable to meet its obligations as they fall due.
- **Market risk**: the Group is exposed to market risk because of positions held in its trading portfolios and its non-trading businesses.
- **Insurance risk**: the Group is exposed to insurance risk, either directly through its businesses or through using insurance as a tool to mitigate other risk exposures.
- **Operational risk**: is the risk arising from the Group's people, processes, systems, physical assets and external events.
- **Regulatory risk**: is the risk arising from failing to meet the requirements and expectations of our many regulators, or from a failure to address or implement any change in these requirements or expectations.

Risk appetite

Risk management across the Group is based on the risk appetite and philosophy set by the Board and the associated risk committees. The Board establishes the parameters for risk appetite for the Group through:

- Setting strategic direction.
- Contributing to, and ultimately approving annual plans for the Group and each division.
- Regularly reviewing and monitoring the Group's performance in relation to risk through monthly Board Reports.

The Board delegates the articulation of risk appetite to GEMC and ensures that this is in line with the strategy and the desired risk reward trade off for the Group. Risk appetite is an expression of the maximum level of residual risk that the Group is prepared to accept in order to deliver its business objectives and is assessed against regular (often daily) controls and stress testing to ensure that the limits are not compromised in abnormal circumstances.

Risk appetite is usually defined in both quantitative and qualitative terms. Whilst different techniques are used to ensure that the Group's risk appetite is achieved, generically they can be classified as follows:

- **Quantitative**: encompassing stress testing, risk concentration, value at risk and credit related metrics, including the probability of default, loss given default and exposure at default.
- **Qualitative**: focusing on ensuring that the Group applies the correct principles, policies and procedures.

The annual business planning and performance management process and associated activities ensure the expression of risk appetite remains appropriate. GRC and GALCO support this work.

Risk organisation

Divisional Chief Executive Officers (CEOs) are specifically responsible for the management of risk within their divisions. As such, they are responsible for ensuring that they have appropriate risk management frameworks that are adequate in design, effective in operation and meet minimum Group standards.

Divisional CEOs are supported by divisional Chief Risk Officers (CROs) and Chief Financial Officers (CFOs). An important element that underpins the Group's approach to the management of all risk is independence. In the case of CROs, it is enforced by joint reporting lines, both operationally to the divisional CEO and functionally to the Group Chief Risk Officer.

Credit risk

Key principles of credit risk management

The objective of credit risk management is to enable the Group to achieve appropriate risk versus reward performance whilst maintaining credit risk exposure in line with approved risk appetite.

Group Risk Management is responsible for setting standards for credit risk management throughout the Group. This is achieved via a combination of governance structures, credit risk policies, control processes and credit systems collectively known as the Group's Credit Risk Management Framework ('CRMF'). The framework is defined in detail in the Group's 'Principles for Managing Credit Risk'.

The key principles for credit risk management as defined in the CRMF are set out below.

- Approval of all credit exposure is granted prior to any advance or extension of credit.
- An appropriate credit risk assessment of the customer and credit facilities is undertaken prior to approval of credit exposure. This includes a review of, amongst other things, the purpose of the credit and sources of repayment, compliance with affordability tests, repayment history, capacity to repay, sensitivity to economic and market developments and risk-adjusted return.
- The Board delegates authority to Advances Committee, Group Credit Committee and divisional credit committees.
- Credit risk authority is specifically granted in writing to all individuals involved in the granting of credit approval, whether this is exercised personally or collectively as part of a credit committee. In exercising credit authority, the individuals act independently.
- Where credit authority is exercised personally, the individual has no responsibility or accountability for related business revenue generation.
- All credit exposures, once approved, are effectively monitored and managed and reviewed periodically against approved limits. Lower quality exposures are subject to a greater frequency of analysis and assessment.
- Customers with emerging credit problems are identified early and classified accordingly. Remedial actions are implemented promptly to minimise the potential loss to the Group.
- Portfolio analysis and reporting is used to identify and manage credit risk concentrations and credit risk quality migration.

Each Division has established its own CRMF consistent with the Group CRMF. Divisional credit departments are responsible for maintaining the CRMF and ensuring that asset quality is within specified parameters. Divisional credit departments are independent of business management and have no direct responsibility or accountability for revenue generation. This independence is supported by the divisional head of credit having dual reporting lines to both the divisional CEO (via the divisional Chief Risk Officer) and to the Head of Group Credit Risk.

GRM undertakes regular assessments of the effectiveness of each divisional CRMF to ensure it complies with Group standards and is appropriate for the business being undertaken. GRC and the GEMC review reports on the Group's portfolio of credit risks on a monthly basis.

Credit approval process

Different credit approval processes exist for each customer type in order to ensure appropriate skills and resources are employed in credit assessment and approval whilst following the key principles relating to credit approval.

Wholesale risk exposures are aggregated to determine the appropriate level of credit approval required and to facilitate consolidated credit risk management.

Credit authority is not extended to relationship managers:

- Assessments of corporate borrower and transaction risk are undertaken using a range of credit risk models supplemented, where appropriate, by management judgement. Specialist internal credit risk departments independently oversee the credit process and make credit decisions or recommendations to the appropriate credit committee.

- Financial Markets counterparties are subject to similar modelling techniques but are approved by a dedicated credit function which specialises in traded market product risk.

Consumer lending and personal businesses employ best practice credit scoring techniques to process small scale, large volume credit decisions. Scores from such systems are combined with management judgement to ensure an effective ongoing process of approval, review and enhancement. Credit decisions for loans above specified thresholds are individually assessed.

Operating and financial review continued

Credit risk models

Credit risk models are used throughout the Group to support the analytical elements of the credit risk management framework, in particular the quantitative risk assessment part of the credit approval process, ongoing credit monitoring as well as portfolio level analysis and reporting.

Credit risk modelling governance

The Group’s ‘Principles for Managing Credit Risk’ outline the governance structure under which all credit risk models must be developed, reviewed and approved. GRM is responsible for:

- Establishing high level standards to which all credit risk models across the Group must adhere and thus ensuring a consistency of approach to credit risk modelling across the Group.
- Approving all credit risk models prior to implementation and reviewing existing models on at least an annual basis.

Divisional credit risk departments own the particular models and are responsible for:

- Developing credit risk models appropriate for the types of borrower and facilities in their credit portfolios and obtaining approval from GRM for their implementation.
- Validating the models and submitting documentation of these validations to GRM with appropriate recommendations on recalibration, where applicable.
- Obtaining approval from GRM for any new methodology or parameter estimates used in existing credit risk models prior to implementation.

Credit risk models used by the Group can be broadly grouped into four categories.

- **Probability of default (‘PD’)/customer credit grade –** these models assess the probability that the customer will fail to make full and timely repayment of credit obligations over a one year time horizon. Each customer is assigned an internal credit grade which corresponds to probability of default. There are a number of different credit grading models in use across the Group, each of which considers particular customer characteristics in that portfolio. The credit grading models use a combination of quantitative inputs, such as recent financial performance and customer behaviour, and qualitative inputs, such as company management performance or sector outlook.

  Every customer credit grade across all grading scales inthe Group can be mapped to a Group level credit grade(see page 43).

- **Exposure at default (‘EAD’)** – these models estimate the expected level of utilisation of a credit facility at the time of a borrower’s default. The EAD will typically be higher than the current utilisation (e.g. in the case where further drawings are made on a revolving credit facility prior to default) but will not typically exceed the total facility limit.The methodologies used in EAD modelling recognise thatcustomers may make more use of their existing creditfacilities in the run up to a default.

- **Loss given default (“LGD”) –** these models estimate the economic loss that may be suffered by the Group on a credit facility in the event of default. The LGD of a facility represents the amount of debt which cannot be recovered and is typically expressed as a percentage of the EAD. The Group’s LGD models take into account the type of borrower, facility and any risk mitigation such as security or collateral held. The LGD may also be affected by the industry sector of theborrower, the legal jurisdiction in which the borrower operatesas well as general economic conditions which may impact thevalue of any assets held as security.

- **Credit risk exposure measurement** – these models calculatethe credit risk exposure for products where the exposure is not 100% of the gross nominal amount of the credit obligation. These models are most commonly used for derivative and other traded instruments where the amount of credit risk exposure may be dependent on external variables such as interest rates or foreign exchange rates.

Credit risk stress testing

Credit risk stress testing measures the potential vulnerability to exceptional but plausible economic and geopolitical events, and seeks to quantify the impact of an adverse change in factors which drive the performance and profitability of a portfolio. Stress testing is used within the Group’s CRMF to estimate and manage potential loss in the portfolio and to support the Board’s internal assessment of adequacy of regulatory capital.

At the Group level, a series of stress events are monitored on a regular basis to assess the potential impact on the Group’s income statement, through the credit impairment charge. The primary objective of this analysis is to support the Group’s framework for managing industry and geographical sector concentrations. This is done through the identification of scenarios which are likely to affect groups of inter-related sectors. These stress tests are discussed with senior divisional management and are reported to GRC, GEMC and the GAC. The Group manages to a trigger limit on the stressed impairment charge for an individual scenario.

In addition, the Group calculates the potential impact of a range of macroeconomic scenarios on both the Group’s income statement and balance sheet. This analysis is discussed by GEMC and reported to the Board.

Credit risk assets

Credit risk assets are an internal risk measure of the Groups exposure to customers. These consist of loans and advances (including overdraft facilities), instalment credit, finance lease receivables, debt securities and other traded instruments across all customer types.

Credit risk assets are typically analysed excluding reverse repurchase agreements due to the short-term nature and low credit risk associated with this product. A breakdown of credit risk assets by division is shown below.

Credit risk assets	2006 £bn	2005 £bn	2004 £bn
Corporate Markets			
Global Banking & Markets	233.4	206.5	185.5
UK Corporate Banking	76.0	66.5	49.7
Retail Markets			
Retail	109.5	104.6	93.9
Wealth Management	10.0	8.9	10.7
Ulster Bank	35.6	30.5	22.3
Citizens	67.5	74.5	59.4
RBS Insurance	7.2	6.7	6.1
	539.2	498.2	427.6

Excluding reverse repurchase agreements, credit risk assets at 31 December 2006 were £539.2 billion (2005 £498.2 billion), an increase of £41 billion (8%) during the year.

An analysis of reverse repurchase agreements is shown below.

Reverse repurchase agreements	2006 £bn	2005 £bn	1 January 2005 £bn
Banks	54.2	41.8	34.5
Customers	62.9	48.9	64.6
	117.1	90.7	99.1

Reverse repurchase agreements as at 31 December 2006 were £117.1 billion (2005 £90.7 billion), an increase of £26.4 billion (29%) during the year.

Credit risk asset quality

Internal reporting and oversight of risk assets is principally differentiated by credit ratings. Internal ratings are used to assess the credit quality of borrowers. Customers are assigned credit ratings, based on various credit grading models that reflect the probability of default. All credit ratings across the Group map to a Group level asset quality scale.

Expressed as an annual probability of default, the upper and lower boundaries and the midpoint for each of these Group level asset quality grades are as follows:

Asset quality grade	Annual probability of default Minimum %	Midpoint %	Maximum %	S&P equivalent
AQ1	0.00	0.10	0.20	AAA to BBB-
AQ2	0.21	0.40	0.60	BB+ to BB
AQ3	0.61	1.05	1.50	BB- to B+
AQ4	1.51	3.25	5.00	B+ to B
AQ5	5.01	52.50	100.00	B and below

Distribution of credit risk assets by asset quality

Asset quality remained broadly stable throughout 2006. As at 31 December 2006, exposure to investment grade counterparties (AQ1) accounted for 46% (2005 47%) of credit risk assets and 97% (2005 97%) of exposures were to counterparties rated AQ4 or higher. The exposure to the lowest asset quality (AQ5) remained at 3%.

Note: Graph data are shown net of provisions and reverse repurchase agreements.

Operating and financial review continued

Distribution of credit risk assets by industry sector

Industry analysis plays an important part in assessing potential concentration risk from within the loan portfolio. Particular attention is given to industry sectors where the Group believes there is a high degree of risk or potential for volatility in the future.

The Group also uses scenario analysis and stress testing in order to monitor the risk to clusters of correlated industry sectors.

Note: Graph data are shown net of provisions and reverse repurchase agreements.

As at 31 December 2006, 28% of credit risk assets (2005 – 30%) related to individuals and include mortgage lending and other smaller loans that are intrinsically well-diversified. Corporate industry exposure comprised 36% of credit risk assets (2005 – 35%), which are well diversified across a range of sectors. Banks and financial sevices account for 20% of credit risk assets (2005 – 22%) and public sector and quasi government credit risk assets make up the remaining 16% (2005 – 13%).

Distribution of credit risk assets by geography

The Group operates in 43 countries, but with the majority of assets in the UK, North America and Europe.

Business growth resulted in the proportion of credit risk assets in Europe and the Rest of the World increasing to 26% from 23%, while exchange rate movements led to a reduction in the proportion in North America from 27% to 25%.

Distribution of credit risk assets by product and customer type

The Group also monitors its credit portfolio by customer type and product type. The largest category is lending to corporate customers, which represented 35% of credit risk assets as at 31 December 2006 (2005 31%). Debt securities issued by banks, sovereigns and quasi government bodies and mortgage lending to individuals accounted for 19% (2005 15%) and 20% (2005 21%) respectively.

Operating and financial review continued

Loan impairment

The Group classifies impaired assets as either Risk Elements in Lending (REIL) or Potential Problem Loans (PPL). REIL represents non-accrual loans, loans that are accruing but are past due 90 days and restructured loans. PPL represents impaired assets which are not included in REIL but where known information about possible credit problems cause management to have serious doubts about the future ability of the borrower to comply with loan repayment terms.

Both REIL and PPL are reported gross of the value of any security held, which could reduce the eventual loss should it occur, and gross of any provision marked. Therefore impaired assets which are highly collateralised, such as mortgages, will have a low coverage ratio of provisions held against reported impaired balance.

The adoption of IAS 39 under IFRS at the beginning of 2005 resulted in changes to the methodology used to identify impaired assets and therefore the way that REIL is calculated. Comparative financial information is given in the following tables for both 1 January 2005 and 31 December 2004.

The table below sets out the Group's loans that are classified as REIL and PPL:

REIL and PPL	2006 £m	2005 £m	1 January 2005 £m	31 December 2004 £m
Non-accrual loans (1)	6,232	5,926	5,836	4,733
Accrual loans past due 90 days (2)	105	9	52	713
Troubled debt restructurings (3)	—	2	—	24
Total REIL	6,337	5,937	5,888	5,470
PPL (4)	52	19	11	280
Total REIL and PPL	6,389	5,956	5,899	5,750
REIL and PPL as % of customer loans and advances — gross (5)	1.57%	1.60%	1.84%	1.92%

Following the implementation of IAS 39 in 2005, the sub-categories of REIL and PPL are calculated as per notes 1 to 4 below.

Notes:

(1) All loans against which an impairment provision is held are reported in the non-accrual category.

(2) Loans where an impairment event has taken place but no impairment recognised. This category is used for fully collateralised non-revolving credit facilities.

(3) Troubled debt restructurings represent loans that have been restructured following the granting of a concession by the Group to the borrower.

(4) Loans for which an impairment event has occurred but no impairment provision is necessary. This category is used for fully collateralised advances and revolving credit facilities where identification as 90 days overdue is not feasible.

(5) Gross of provisions and excluding reverse repurchase agreements.

REIL as at 31 December 2006 was £6,337 million (2005 £5,937 million), an increase of £400 million (7%) during the year.

As a percentage of customer lending, REIL and PPL in aggregate show an improving trend, amounting to 1.57% of customer loans and advances at 31 December 2006 (2005 1.60%).

REIL by division

The table below shows REIL by division.

REIL	2006 £m	2005 £m	1 January 2005 £m	31 December 2004 £m
Corporate Markets				
Global Banking & Markets	492	496	1,066	937
UK Corporate Banking	1,034	969	1,032	955
Retail Markets				
Retail	4,143	3,877	3,197	3,000
Wealth Management	43	58	65	99
Ulster Bank	433	342	389	341
Citizens	175	195	136	135
Other	17		3	3
Total REIL	6,337	5,937	5,888	5,470

During 2006, REIL in Corporate Markets rose by £61 million but remained at historically low levels reflecting continued favourable conditions in the corporate environment in the UK, Europe and the US. In addition, REIL increased in Retail by £266 million (7%) due to ongoing challenging conditions in the UK consumer environment.

Impairment loss provision methodology

Provisions for impairment losses are assessed under three categories as described below:

Individually assessed provisions are the provisions required for individually significant impaired assets which are assessed on a case by case basis, taking into account the financial condition of the counterparty and any guarantor. This incorporates an estimate of the discounted value of any recoveries and realisation of security or collateral. The asset continues to be assessed on an individual basis until it is repaid in full, transferred to the performing portfolio or written-off.

Collectively assessed provisions are provisions on impaired credits below an agreed threshold which are assessed on a portfolio basis, to reflect the homogeneous nature of the assets, such as credit cards or personal loans. The provision is determined from a quantitative review of the relevant portfolio, taking account of the level of arrears, security and average loss experience over the recovery period.

Latent loss provisions are provisions held against the estimated impairment in the performing portfolio which have yet to be identified as at the balance sheet date. To assess the latent loss within the portfolios, the Group has developed methodologies to estimate the time that an asset can remain impaired within a performing portfolio before it is identified and reported as such.

Provision analysis

The Group's consumer portfolios, which consist of small value, high volume credits, have highly efficient largely automated processes for identifying problem credits and very short timescales, typically three months, before resolution or adoption of various recovery methods.

Corporate portfolios consist of higher value, lower volume credits, which tend to be structured to meet individual customer requirements. Provisions are assessed on a case by case basis by experienced specialists, with input from professional valuers and accountants as appropriate. The Group operates a clear provisions governance framework which sets thresholds whereby suitable oversight and challenge is undertaken. These opinions and levels of provision are overseen by each division's Provision Committee, with representation from Group Risk Management. In addition, significant cases are presented to, and challenged by, the Group Problem Exposure Review Forum.

Early and active management of problem exposures ensures that credit losses are minimised. Specialised units are used for different customer types to ensure that the appropriate risk mitigation is taken in a timely manner.

Portfolio provisions are reassessed regularly as part of the Group's ongoing monitoring process.

The adoption of IAS 39 at the beginning of 2005 resulted in changes to the methodology used to identify impaired assets and to calculate required provisions.

Loan impairment charge	2006 £m	2005 £m	2004 £m
Latent loss provisions charge	87	14	
Collectively assessed provisions charge	1,573	1,399	
Individually assessed provisions charge	217	290	
Specific provision charge			1,386
General provision charge			16
Total charge to income statement	1,877	1,703	1,402

Charge as a % of customer loans and advances gross (1)	0.46%	0.46%	0.47%

Notes:

(1) Gross of provisions and excluding reverse repurchase agreements.

Provisions for loan impairment charged to the income statement in 2006 were £1,877 million, up £174 million (10%) from 2005. As a percentage of customer lending, the impairment charge remained flat at 0.46% .

Operating and financial review continued

Summary of loan impairment provisions
A summary of the total customer provisions balance is shown in the table below.

Loan impairment provisions (1)	2006 £m	2005 £m	1 January 2005 £m	31 December 2004 £m
Latent loss provisions	593	543	570	
Collectively assessed provisions	2,645	2,587	2,484	
Individually assessed provisions	695	754	1,086	
Specific provisions				3,607
General provision				561
Total provisions	3,933	3,884	4,140	4,168
Total provision as a % of customer loans and advances gross (2)	1.0%	1.0%	1.3%	1.4%

Notes:

(1) Excludes provisions against loans and advances to banks of £2 million (2005 £3 million; 1 January 2005 £5 million, 31 December 2004 £6 million).

(2) Gross of provisions and excluding reverse repurchase agreements.

As at 31 December 2006 total customer provisions were £3,933 million, up £49 million (1%) from 31 December 2005. The movement in the provisions balance is shown at the bottom of the page.

Provisions coverage

The Groups provision coverage ratios are shown in the table below.

	2006	2005	1 January 2005	31 December 2004
Total provision expressed as a: % of REIL	62%	65%	70%	76%
% of REIL and PPL	62%	65%	70%	72%

The coverage ratio of closing provisions to REIL and PPL decreased from 65% to 62% during 2006. The lower coverage ratio reflects amounts written-off and the changing mix from unsecured to secured exposures.

Movement in loan impairment provisions balance

The movement in provisions balance during 2006 is shown in the table below.

	2006 £m	2005 £m
Balance as at 1 January	3,887	4,145
Currency translation and other adjustments	(61)	51
Amounts written-off	(1,841)	(2,040)

Recoveries of amounts previously written-off	215	172
Charge to income statement	1,877	1,703
Discount unwind (1)	(142)	(144)
Balance as at 31 December (2)	3,935	3,887

Notes:

(1) The impact of discounting inherent within the provisions balance is unwound as the time to receiving the expected recovery cash flows draws nearer.

(2) Includes provisions against loans and advances to banks of £2 million (2005 £3 million).

An impairment provision calculated using the effective interest rate method leaves a discounted asset; the discount unwinds at a constant effective rate until the outstanding asset is completely realised.

Liquidity risk

Liquidity management within the Group focuses on both overall balance sheet structure and the control, within prudent limits, of risk arising from the mismatch of maturities across the balance sheet and from undrawn commitments and other contingent obligations.

The management of liquidity risk within the Group is undertaken within limits and other policy parameters set by GALCO, which reviews monthly, and receives on an exception basis, reports detailing compliance with those policy parameters. A weekly report is also provided to the Groups executive management. Compliance is monitored and coordinated daily under the stewardship of the Group Treasury function, both in respect of internal policy and the regulatory requirements of the Financial Services Authority.

Detailed liquidity position reports are compiled each day by Group Treasury and reviewed daily and weekly with Global Banking & Markets, who manage day-to-day and intra-day market execution within the policy parameters set.

In addition to their consolidation within the Groups daily liquidity management process, it is also the responsibility of all Group subsidiaries and branches outside the UK to ensure compliance with any separate local regulatory liquidity requirements where applicable, subject to Group Treasury oversight.

Diversification of funding sources

The structure of the Groups balance sheet is managed to maintain substantial diversification, to minimise concentration across its various deposit sources, and to contain the level of reliance on total short-term wholesale sources of funds (gross and net of repos) within prudent levels. As part of the Groups planning process, the forecast structure of the balance sheet is regularly reviewed over the plan horizon and funding strategies and options are developed by Group Treasury and implemented after review and approval by GALCO.

The level of large deposits taken from banks, corporate customers, non-bank financial institutions and other customers, and significant cash outflows therefrom, are also reviewed to monitor concentration and identify any adverse trends. During 2006 the Groups funding sources remained well diversified by counterparty, instrument and maturity.

	2006		2005		2004	
Sources of funding	£m	%	£m	%	£m	%
Customer accounts (excluding repos)						
Repayable on demand	197,771	28	172,853	27	169,016	32
Time deposits	122,467	17	121,260	19	72,165	14
Total customer accounts (excluding repos)	320,238	45	294,113	46	241,181	46
Debt securities over one year remaining maturity	44,006	6	22,293	3	9,931	2
Subordinated liabilities	27,654	4	28,274	4	20,366	4
Shareholders equity	40,227	6	35,435	6	33,905	6
	432,125	61	380,115	59	305,383	58
Debt securities up to one year remaining maturity	41,957	5	68,127	11	54,068	10
Repo agreements with customers	63,984	9	48,754	7	42,134	8
Deposits by banks (excluding repos)	55,767	8	62,502	10	56,541	11
Repo agreements with banks	76,376	11	47,905	7	43,342	8
Short positions	43,809	6	37,427	6	28,923	5

Total	714,018	100	644,830	100	530,391	100

Customer accounts (excluding repos), term debt securities of over one year remaining maturity and capital continue to represent the core of the Groups funding. These core funds in total increased by £52.0 billion (14%) over the course of 2006 and represent 61% of total funding excluding other liabilities at 31 December 2006.

Customer accounts continue to provide a substantial proportion of the Groups funding and comprise a well diversified and stable source of funds from a wide range of retail, corporate and non-bank institutional customers. Excluding repo agreements, customer accounts grew by £26.1 billion (9%), and represent 45% of total funding excluding other liabilities at 31 December 2006.

Term debt securities with an outstanding term of over one year increased £21.7 billion (97%) to represent 6% of the Groups funding at 31 December 2006, reflecting the activity of the Group in raising term funds through its securitisation and Euro and US Medium Term Note programmes.

Capital (shareholders equity and subordinated debt) increased by £4.2 billion (7%) and provides 10% of total funding excluding other liabilities.

Operating and financial review continued

Short term wholesale deposits are taken from a wide range of counterparties, with the largest single depositor continuing to represent less than 1% of the Group's total funding. The level of funding from short term unsecured debt issuance and bank deposits, excluding repos and short positions, has decreased by £32.9 billion (25%) and now represents 13% of total funding excluding other liabilities at 31 December 2006. This reflects the increased use of secured and unsecured term issuance to fund the higher rate of growth in customer loans and advances (see 'net customer activity' below) and increased repo activity.

Short positions and repos with corporate, institutional customers and banks are undertaken primarily by RBS Greenwich Capital in the US and by Global Banking & Markets. Repos and short positions increased by £50.1 billion (37%) to represent 26% of total funding excluding other liabilities at 31 December 2006.

The Group remains well placed to access various wholesale funding sources from a wide range of counterparties and markets.

Net customer activity

Net customer lending, excluding repos, rose by £9.6 billion (as the growth in loans and advances to customers continued to exceed the growth in customer accounts, albeit to a lesser degree than in previous years), thus increasing the degree of reliance on wholesale market funding to support loan growth.

Net customer activity	2006 £m	2005 £m	2004 £m
Loans and advances to customers (gross, excluding reverse repos)	407,918	372,223	299,235
Customer accounts (excluding repos)	320,238	294,113	241,181
Customer lending less customer accounts	87,680	78,110	58,054
Loans and advances to customers as a % of customer accounts (excluding repos)	127.4%	126.6%	124.1%

The Group evaluates on a regular basis its structural liquidity risk and applies a variety of balance sheet management and term funding strategies to maintain this risk within its normal policy parameters.

Management of term structure

The degree of maturity mismatch within the overall long-term structure of the Group's assets and liabilities is managed within internal policy guidelines, to ensure that term asset commitments may be funded on an economic basis over their life. In managing its overall term structure, the Group analyses and takes into account the effect of retail and corporate customer behaviour on actual asset and liability maturities where they differ materially from the underlying contractual maturities.

Stress testing

The maintenance of high quality credit ratings is recognised as an important component in the management of the Group's liquidity risk. Credit ratings affect the Group's ability to raise, and the cost of raising, funds from the wholesale market and the need to provide collateral in respect of, for example, changes in the mark-to-market value of derivative transactions.

Given its strong credit ratings, the impact of a single notch downgrade would, if it occurred, be expected to have a relatively small impact on the Group's economic access to liquidity. More severe downgrades could have a progressively greater impact but have an increasingly lower probability of occurrence.

As part of its stress testing of its access to sufficient liquidity, the Group regularly evaluates the potential impact of a range of levels of downgrade in its credit ratings and carries out stress tests of other relevant scenarios and sensitivity analyses.

Contingency funding plans are maintained to anticipate and respond to any approaching or actual material deterioration in market conditions or in the Group's credit ratings, and the Group remains confident of its ability to manage its liquidity requirements effectively in all such circumstances.

Daily management

The primary focus of the Group's daily management activity is to ensure access to sufficient liquidity to meet its cashflow obligations within key time horizons out to one month ahead. The short-term maturity structure of the Group's liabilities and assets is managed on a daily basis to ensure that all material cashflow obligations, and potential cashflows arising from undrawn commitments and other contingent obligations, can be met as they arise from day to day, either from cash inflows, from maturing assets, new borrowing or the sale or repurchase of various debt securities held (after allowing for appropriate haircuts). Short-term liquidity risk is managed on a consolidated basis for the whole Group including the Greenwich companies but excluding the activities of Citizens and insurance businesses, which are subject to regulatory regimes that necessitate local management of liquidity.

Internal liquidity mismatch limits are set for all other subsidiaries and non-UK branches which have material local treasury activities in external markets, to ensure those activities do not compromise daily maintenance of the Group's overall liquidity risk position within the Group's policy parameters.

Citizens and the insurance companies have their own liquidity policies which comply with their respective regulatory regimes. The policies are also reviewed and monitored by Group Treasury.

Net short-term wholesale market activity	2006 £m	2005 £m	2004 £m
Debt securities, treasury and other eligible bills	132,742	126,503	100,018
Reverse repo agreements with banks and customers	117,060	90,691	82,159
Less: repos with banks and customers	(140,360)	(96,659)	(85,476)
Short positions	(43,809)	(37,427)	(28,923)
Insurance Companies debt securities held	(6,149)	(5,724)	(5,029)
Debt securities charged as security for liabilities	(8,560)	(9,578)	(4,852)
Net marketable assets	50,924	67,806	57,897
By remaining maturity up to one month:			
Deposits by banks (excluding repos)	36,089	35,153	34,041
Less: loans and advances to banks (gross, excluding reverse repos)	(21,136)	(16,381)	(17,067)
Debt securities in issue	19,924	20,577	15,505
Net wholesale liabilities due within one month	34,877	39,349	32,479
Net surplus of marketable assets over wholesale liabilities due within one month	16,047	28,457	25,418

Whilst the Groups net surplus of marketable assets over net short-term wholesale liabilities due within one month decreased by £12.4 billion (44%), access to liquidity to meet all foreseen needs remains comfortably within the Groups policy parameters. The Group has increased its reliance on medium term funding, both unsecured (via medium term notes) and secured (via residential mortgage securitisation). In the banking book, this has reduced the relative reliance on short term unsecured funding and consequently the level of short-term liquidity risk. In the trading book, an increased proportion of the higher overall level of marketable assets held has been used as collateral for repo borrowing.

Sterling liquidity

Over 43% of the Groups total assets are denominated in sterling. For its sterling activity the FSA requires the Group, on a consolidated basis, to maintain daily a minimum ratio of 100% between:

1. a stock of qualifying high quality liquid assets (primarily UK and EU government securities, treasury bills and cash held in branches); and
2. the sum of:
   - sterling wholesale net outflows contractually due within five working days (offset up to a limit of 50%, by 85% of sterling certificates of deposit held which mature beyond five working days); and
   - 5% of retail deposits with a residual contractual maturity of five working days or less.

The Group exceeded the minimum ratio requirement throughout 2006.

The FSA also sets an absolute minimum level for the stock of qualifying liquid assets that the Group is required to maintain each day. The Group has exceeded that minimum stock requirement at all times during 2006.

The Groups operational processes are actively managed to ensure that both the minimum sterling liquidity ratio and the minimum stock requirement are achieved or exceeded at all times.

Recognising that there are some gaps in the scope of the liquidity risk parameters covered by the FSAs sterling regime, the Group is actively developing an all-currency mismatch approach for the management of its liquidity risk, in line with its current approach for non-sterling currencies (see below) whilst continuing to ensure compliance with the FSAs separate requirements for its sterling activity.

Liquidity in non-sterling currencies

For non-sterling currencies, no specific regulatory liquidity requirement is currently set for the Group by the FSA. However, the importance of managing prudently the liquidity risk in its non-sterling activities is recognised and the Group manages its non-sterling liquidity risk daily within net mismatch limits set for the 0-8 calendar day and 0-1 month periods as a percentage of the Groups total deposit and debt liabilities.

In measuring its non-sterling liquidity risk, due account is taken of the marketability within a short period of the wide range of debt securities held. Appropriate adjustments are applied in each case, dependent on various parameters, to determine the Groups ability to realise cash at short notice via the sale or repo of such marketable assets if required to meet unexpected outflows.

Operating and financial review continued

The level of contingent risk from the potential drawing of undrawn or partially drawn commitments, back-up lines, standby lines and other similar facilities is also actively monitored and reflected in the measures of the Group's non-sterling liquidity risk. Particular attention is given to the US$ commercial paper market and the propensity of the Group's corporate counterparties who are active in raising funds from that market to switch to utilising facilities offered by the Group in the event of either counterparty specific difficulties or a significant widening of interest spreads generally in the commercial paper market.

The Group also provides liquidity back-up facilities to both its own conduits and certain other conduits which take funding from the commercial paper market. Limits sanctioned for such facilities totalled less than £12 billion at 31 December 2006. The short-term contingent liquidity risk in providing such backup facilities is also mitigated by the spread of maturity dates of the commercial paper taken by the conduits.

The Group has operated within its non-sterling liquidity policy mismatch limits at all times during 2006 and operational processes are actively managed to ensure that is the case going forward.

Developments in liquidity risk management regulation

Following the Basel Committee's publication of Sound Practices for Managing Liquidity in Banking Organisations in February 2000, a number of regulatory bodies internationally began reviewing their regulatory liquidity frameworks.

In the UK, the FSA published a discussion document - DP24 - in October 2003 setting out draft proposals for a new quantitative framework to operate in the UK. Comments made to the FSA, by the Group and other banks collectively, in response to these proposals, made clear the desirability of an internationally co-ordinated approach to the regulation of liquidity. An international forum of regulators, chaired jointly by the FSA and the US Federal Reserve Bank, published their findings in 2006 but no specific recommendations were made. During 2007 it is expected that further work by international regulators will be undertaken.

New quantitative liquidity regulation is being developed by a number of local regulators and will impact the Group's overseas subsidiaries and branches, notably in the Republic of Ireland. We do not foresee any difficulty in meeting the new requirements.

The Group has been, and continues to be, actively involved in working with the various regulatory bodies to assist the development of an appropriate future regulatory liquidity regime which takes into account local national considerations but also gives due recognition to the integrated cross-border approach to the management of liquidity risk within most international banking groups.

Taking account of the indicative future regulatory requirements published to date, the Group continues to develop its liquidity risk reporting, management and stress testing capabilities.

Market risk

Market risk is defined as the risk of loss as a result of adverse changes in risk factors including interest rates, foreign currency and equity prices together with related parameters such as market volatilities.

The Group is exposed to market risk because of positions held in its trading portfolios as well as its non-trading business including the Group's treasury operations.

Market risk management process

GEMC approves the Group's trading book market risk appetite, expressed in value-at-risk ('VaR') and stress testing limits. These limits are delegated to individual trading businesses within Global Banking & Markets.

The delegation of market risk authority to the Groups trading businesses is set out in the Groups Market Risk Policy Statement (MRPS), which also sets out standards by which trading market risk must be managed throughout the Group.

The Group Market Risk function, which is independent of the Groups trading businesses, is responsible for setting and monitoring the adequacy and effectiveness of the Groups market risk management processes. This includes overseeing the effective application and compliance with the Groups MRPS. The businesses are responsible for the market risks that they assume and for remaining within their defined limits.

Sources of market risk
Trading

The principal trading book market risk factors for the Group are interest rates, credit spreads and foreign exchange.

The primary focus of the Groups trading activities is client facilitation providing products to the Groups client base at competitive prices. The Group also undertakes: market making quoting firm bid (buy) and offer (sell) prices with the intention of profiting from the spread between the quotes; arbitrage entering into offsetting positions in different but closely related markets in order to profit from market imperfections; and proprietary activity taking positions in financial instruments as principal in order to take advantage of anticipated market conditions.

Financial instruments held in the Groups trading portfolios include, but are not limited to: debt securities, loans, deposits, securities sale and repurchase agreements and derivative financial instruments (futures, forwards, swaps and options). For a discussion of the Groups accounting policies for, and information with respect to, its exposures to derivative financial instruments, see Accounting policies and Note 19 on the accounts.

Non-trading

The principal market risks arising from the Group's non-trading activities are interest rate risk, currency risk and equity risk. Treasury activity and mismatches between the repricing of assets and liabilities in its retail and commercial banking operations account for most of the non-trading interest rate risk. Non-trading currency risk derives from the Group's investments in overseas subsidiaries, associates and branches. The Group's venture capital portfolio and investments held by its general insurance business are the principal sources of non-trading equity price risk. The Group's portfolios of non-trading financial instruments mainly comprise loans (including finance leases), debt securities, equity shares, deposits, certificates of deposit and other debt securities issued, loan capital and derivatives. To reflect their distinct nature, the Group's long-term assurance assets and liabilities attributable to policyholders have been excluded from these market risk disclosures.

Market risk methodology: trading

The Group manages the market risk in its trading and treasury portfolios through its market risk management framework. This expresses limits based on, but not limited to:

(i) VaR
(ii) Stress testing and scenario analysis
(iii) Position and sensitivity analyses

(i) VaR

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

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

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

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

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

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

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

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

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

	2006				2005			
Trading	Average £m	Period end £m	Maximum £m	Minimum £m	Average £m	Period end £m	Maximum £m	Minimum £m
Interest rate	8.7	10.2	15.0	5.7	7.3	7.4	10.9	5.1
Credit spread	13.2	14.1	15.7	10.4	11.4	11.8	14.4	8.8
Currency	2.2	2.5	3.5	1.0	1.8	1.4	10.7	0.5
Equity and commodity	1.4	1.6	4.3	0.6	0.5	0.7	1.1	0.2
Diversification		(12.8)				(8.5)		
Total trading VaR	14.2	15.6	18.9	10.4	13.0	12.8	16.5	9.9

Operating and financial review continued

Backtesting

The Group undertakes a programme of daily backtesting, which compares the actual profit or loss realised in trading activity to the VaR estimation. The results of the backtesting process are one of the methods by which the Group monitors the ongoing suitability of its VaR model. Backtesting exceptions are those instances when a realised loss exceeds the predicted VaR. At the 99% confidence level, no more than one backtesting exception is expected every 100 trading days. The Group experienced no backtesting exceptions at legal entity level during 2006.

The Group’s trading activities are carried out principally by Global Banking & Markets. The chart below depicts the number of days on which Global Banking & Markets’ trading income fell within stated ranges.

(ii) Stress testing

Stress testing measures the impact of abnormal changes in market rates and prices on the fair value of the Group’s trading portfolios. GEMC approves the high-level market risk stress test limit for the Group.

The Group calculates a range of market risk stress tests each day. The objective of stress testing is to identify the loss that the Group’s current portfolio of trading book exposures would generate in plausible but adverse market events. The Group calculates historical stress tests and hypothetical stress tests. Historical stress tests calculate the loss that would be generated if the market movements that occurred during a historical market event were to be repeated. Hypothetical stress tests calculate the loss that would be generated if a specific set of adverse market movements were to occur.

In addition to the Group-level consolidated market risk stress tests, stress testing is also undertaken at key trading strategy level. Additional stress tests are undertaken for those strategies where the associated market risks are not adequately captured by VaR.

Stress test exposures are discussed with senior management and are reported to GRC, GEMC and the Board. Breaches in the Group’s market risk stress testing limit are reported to GEMC.

(iii) Position risk and sensitivity analyses

In addition to the VaR and stress testing measures discussed above, the Group calculates a wide range of sensitivity and position risk measures, for example interest rate ladders or option revaluation matrices. These measures provide valuable additional controls, often at individual desk or strategy level.

Market risk methodology: non-trading

Non-trading interest rate risk arises from the Group's treasury activities and retail and commercial banking businesses. It is the Group's policy to minimise the sensitivity of net accrual earnings to changes in interest rates and where interest rate risk is retained, to ensure that appropriate resources, measures and limits are applied.

Treasury

The Group's treasury activities include its money market business and the management of internal funds flow within the Group's businesses. Money market portfolios include cash instruments (principally debt securities, loans and deposits) and related hedging derivatives. VaR for the Group's treasury portfolios, which relates mainly to interest rate risk including credit spreads, was £1.5 million at 31 December 2006 (2005 – £3.5 million). During the year the maximum VaR was £4.4 million (2005 – £5.8 million), the minimum £0.6 million (2005 – £2.8 million) and the average £2.4 million (2005 – £4.0 million).

Retail and commercial banking

Non-trading interest rate risk can arise in these activities from a variety of sources, including where assets, liabilities and off-balance sheet instruments have different repricing dates.

Non-trading interest rate risk is calculated in each business on the basis of establishing the repricing behaviour of each asset, liability and off-balance sheet product. For many products, the actual interest rate repricing characteristics differ from the contractual repricing. In most cases, the repricing maturity is determined by the market interest rate that most closely fits the historical behaviour of the product interest rate. For non-interest bearing current accounts, the repricing maturity is determined by the stability of the portfolio. The repricing maturities used are approved by Group Treasury and divisional asset and liability committees at least annually. Key conventions are reviewed annually by GALCO.

A static maturity gap report is produced as at the month-end for each business, in each functional currency based on the behaviouralised repricing for each product. It is Group policy to include in the gap report, non-financial assets and liabilities, mainly property, plant and equipment and the Group's capital and reserves, spread over medium and longer term maturities. This report also includes hedge transactions, principally derivatives.

Any residual non-trading interest rate exposures are controlled by limiting repricing mismatches in the individual business balance sheets. Potential exposures to interest rate movements in the medium to long term are measured and controlled using a version of the same VaR methodology that is used for the Group's trading portfolios but without discount factors. Net accrual income exposures are measured and controlled in terms of sensitivity over time to movements in interest rates.

Risk is managed, within VaR limits approved by GALCO, through the execution of cash and derivative instruments. Execution of the hedging is carried out by the relevant division through the Group's treasury functions. The residual risk position is reported to divisional asset and liability committees, GALCO and the Board.

Non-trading interest rate VaR

Non-trading interest rate VaR for the Group's treasury and retail and commercial banking activities was £40.2 million at 31 December 2006 (2005 – £81.5 million) with the major exposure being to changes in longer term US dollar interest rates. During the year, the maximum VaR was £98.7 million (2005 – £104.2 million), the minimum £40.2 million (2005 – £10.8 million) and the average £76.6 million (2005 – £65.5 million).

Citizens was the main contributor to the Group's non-trading interest rate VaR. It invests in a portfolio of highly rated and liquid investments, principally mortgage-backed securities. This balance sheet management approach is common for US retail banks where mortgages are originated and then sold to Federal agencies for funding through the capital markets. VaR, like all interest rate risk measures, has its limitations when applied to retail banking books and the management of Citizens' interest rate exposures involves a number of other interest rate risk measures and related limits. Two measures that are reported both to Citizens ALCO and the Board are:

- the sensitivity of net accrual earnings to a series of parallel movements in interest rates; and
- economic value of equity (EVE) sensitivity to a series of parallel movements in interest rates.

Operating and financial review continued

The limits applied to these measures are set to parallel movements of +/-1% and +/-2%. The EVE methodology captures deposit re-pricing strategies and the embedded option risks that exist within both the investment portfolio of mortgage-backed securities and the consumer loan portfolio.

EVE is the present value of the cash flows generated by the current balance sheet. EVE sensitivity to a 2% parallel movement upwards and downwards in US interest rates is shown below.

	Percent increase/(decrease) in Citizens EVE	
2006	2% parallel upward movement in US interest rates %	2% parallel downward movement in US interest rates (no negative rates allowed) %
Period end	(9.6)	(7.2)
Maximum	(10.1)	(10.3)
Minimum	(8.4)	(1.9)
Average	(9.4)	(6.0)
2005		
Period end	(9.1)	(8.2)
Maximum	(10.1)	(9.8)
Minimum	(7.1)	(4.4)
Average	(9.2)	(7.9)

For the Group, the other major structural interest rate risk arises from a low interest rate environment, particularly in sterling, sustained for a number of years. In such a scenario, deposit pricing may reach effective floors below which it is not practical to reduce rates further whilst variable rate asset pricing continues to decline. A sustained low rate scenario would also generate progressively reduced income from the medium and long term hedging of non-interest bearing liabilities. GALCO regularly reviews the impact of stress scenarios including the impact of substantial declines in rates to ensure that appropriate risk management strategies are employed. Resulting action may involve execution of derivatives, product development and tactical pricing changes.

Note 35 on the accounts includes, on pages 153 and 154, tables that summarise the Group's interest rate sensitivity gap for its non-trading book at 31 December 2006 and 31 December 2005. The tables show the contractual re-pricing for each category of asset, liability and for off-balance sheet items and do not reflect the behaviouralised repricing used in the Group's asset and liability management methodology and the non-trading interest rate VaR presented above.

- **Currency risk**

The Group does not maintain material non-trading open currency positions other than the structural foreign currency translation exposures arising from its investments in foreign subsidiaries and associated undertakings and their related currency funding. The Group's policy in relation to structural positions is to match fund the structural foreign currency exposure arising from net asset value, including goodwill, in foreign subsidiaries, equity accounted investments and branches, except where doing so would materially increase the sensitivity of either the Group's or the subsidiary's regulatory capital ratios to currency movements. The policy requires structural foreign exchange positions to be reviewed regularly by GALCO. Foreign exchange differences arising on the translation of foreign operations are recognised directly in equity together with the effective portion of foreign exchange differences arising on hedging liabilities.

The tables below set out the Group’s structural foreign currency exposures.

2006	Net investments in foreign operations £m	Foreign currency borrowings hedging net investments £m	Structural foreign currency exposures £m
US dollar	15,036	5,278	9,758
Euro	3,059	1,696	1,363
Swiss franc	462	457	5
Chinese RMB	3,013	–	3,013
Other non-sterling	132	107	25
	21,702	7,538	14,164
2005			
US dollar	15,452	6,637	8,815
Euro	2,285	139	2,146
Swiss franc	431	430	1
Chinese RMB	914	–	914
Other non-sterling	76	72	4
	19,158	7,278	11,880

The increase in the US dollar open structural foreign currency exposure over 2005 was created in order to minimise the impact of movements in the US dollar exchange rate against sterling on the Group’s capital ratios. The increase in the Chinese RMB position reflects the uplift in the value of the Group’s strategic investment in Bank of China.

• **Equity risk**

Non-trading equity risk arises principally from the Group’s strategic investments, its venture capital activities and its general insurance business.

VaR is not an appropriate risk measure for the Group’s venture capital investments, which comprise a mix of quoted and unquoted investments, or its portfolio of strategic investments. These investments are carried at fair value with changes in fair value recorded in profit or loss, or in equity.

Insurance risk

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

An insurance contract transfers risk from the policyholder to the insurer, whereby, in return for a premium paid, the insurer indemnifies the policyholder on the occurrence of specified events.

Insurance risk is the risk of fluctuations in the timing, frequency or severity of insured events, relative to the expectations of the Group at the time of underwriting. This risk is managed according to the following separate components:

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

Insurance risk is predictable, especially with the analysis of large volumes of data over time. There is, however, uncertainty around the predictions from various sources, for example, volatility of the weather. However, the Group has documented risk policies, coupled with governance frameworks to oversee and control and hence minimise the risks.

Underwriting and pricing risk

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

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

Operating and financial review continued

Claims management risk

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

Reinsurance risk

Reinsurance is used to protect against the impact of major catastrophic events or unforeseen volumes of, or adverse trends in, large individual claims and to transfer risk that is outside the Group's current risk appetite.

The following types of reinsurance are used where appropriate:

- Excess of loss 'per individual risk' reinsurance to protect against significantly large individual losses.
- Excess of loss catastrophic 'event' reinsurance to protect against major events, for example, windstorms or floods.
- Quota share reinsurance to protect against unforeseen adverse trends, where the reinsurer takes an agreed percentage of premiums and claims.
- Other forms of reinsurance may be utilised according to need, subject to approval by senior management or the board as appropriate.

Reinsurance of risks above the Group's risk appetite is only effective if the reinsurance premium payable makes economic sense and the counterparty is financially secure. Before entering a contract with a new reinsurer, it must satisfy the Credit Risk Approval process that uses information derived internally and from security ratings agencies. Acceptable reinsurers are rated at A- or better unless specifically authorised by the RBS Insurance Group Board.

Reserving risk

Reserving risk relates to both premiums and claims. It is the risk that reserves are assessed incorrectly such that insufficient funds have been retained to pay or handle claims as the amounts fall due, both in relation to those claims which have already occurred in relation to the claims reserves (including claims handling expense reserves) or will occur in future periods of insurance (in relation to the premium reserves).

a) Premium reserves
In respect of premium reserves, it is the Group's policy to ensure that the net unearned premium reserves are adequate to meet the expected cost of claims and associated expenses in relation to the exposure after the balance sheet date. To the extent that the unearned premium reserves, net of reinsurance and deferred acquisition costs are inadequate, a liability adequacy provision will be held.

b) Claims reserves
It is the Group's policy to hold undiscounted claims reserves (including reserves to cover claims which have been incurred but not reported (IBNR reserves)) for all classes at a sufficient level to meet all liabilities as they fall due, having regard to actuarial estimates and the volatility observed and expected in the claims in each class.

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

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

Frequency and severity of specific risks and sources of uncertainty

Most general insurance contracts written by the Group are issued on an annual basis, which means that the Groups liability extends for a 12 month period, after which the Group is entitled to decline or renew or can impose renewal terms by amending the premium, terms and conditions, or both.

The following paragraphs explain the frequency and severity of claims and the sources of uncertainty for the key classes that the Group is exposed to:

a) Motor insurance contracts (private and commercial)

Claims experience is variable, due to a wide range of factors, but the principal ones are age, sex and driving experience of the driver, type and nature of vehicle and use of vehicle and area.

There are many sources of uncertainty that affect the Groups experience under motor insurance, including operational risk, reserving risk, premium rates not matching claims inflation rates, the weather, the social, economic and legislative environment and reinsurance failure risks.

b) Property insurance contracts (residential and commercial)

The major source of uncertainty in the Groups property accounts is the volatility of weather. Over a longer period, the strength of the economy is also a factor. There are many other sources of uncertainty which include operational and reinsurance issues.

c) Other commercial insurance contracts

Other commercial claims come mainly from business interruption and loss arising from the negligence of the insured (liability insurance). Business interruption losses come from the loss of income, revenue and/or profit as a result of property damage claims. Liability insurance includes employers liability and public/products liability. As liability insurance is written on an occurrence basis, these covers are still subject to claims that are identified over a substantial period of time, but where the loss event occurred during the life of the policy.

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

Life business

The three regulated life companies of the Group, National Westminster Life Assurance Limited, Royal Scottish Assurance plc and Direct Line Life Insurance Company Limited, are required to meet minimum capital requirements at all times under the Financial Service Authoritys Prudential Sourcebook. The capital resources covering the regulatory requirement are not transferable to other areas of the Group. To ensure that the capital requirement is satisfied at all times, each company holds an additional voluntary buffer above the regulatory minimum.

The Group is not exposed to price, currency, credit, or interest risk on unit linked life contracts but it is exposed to variation in management fees. A decrease of 10% in the value of the assets would reduce the asset management fees by £5 million per annum (2005 £5 million). The Group also writes insurance contracts with minimum guaranteed death benefits that expose it to the risk that declines in the value of underlying investments may increase the Groups net exposure to death risk.

Frequency and severity of claims for contracts where death is the insured risk, the most significant factors that could increase the overall frequency of claims are epidemics or widespread changes in lifestyle, resulting in earlier or more claims than expected.

For contracts where survival is the insured risk, the most significant factor is continued improvement in medical science and social conditions that would increase longevity.

For contracts with fixed and guaranteed benefits and fixed future premiums, there are no mitigating terms and conditions that reduce the insurance risk accepted. Participating contracts can result in a significant portion of the insurance risk being shared with the insured party.

Sources of uncertainty in the estimation of future benefit payments and premium receipts the Group uses base tables of standard mortality appropriate to the type of contract being written and the territory in which the insured person resides. These are adjusted to reflect the Groups experience, mortality improvements and voluntary termination behaviour.

Operating and financial review continued

Operational risk

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

The Group's Operational Risk Management Framework ("ORMF") provides the direction for delivering effective operational risk management. The ORMF comprises the policy, principles and procedures that enable the consistent identification, assessment, mitigation, monitoring and reporting of operational risk across the Group in a cost-effective manner.

The objectives of the framework are to protect the Group from financial loss or damage to its reputation and to ensure that it meets all necessary regulatory and legal requirements.

The Group's central Operational Risk function is responsible for the ORMF. It is the responsibility of the businesses to implement the framework. The businesses are required to identify where and how the business is exposed to the risk of loss; assess the extent of the risk exposure; control and mitigate the risk and monitor and report the operational risk exposure and highlight any action required.

The Group's risk management processes are designed to ensure that enterprise risk issues are identified quickly, escalated and managed. Operational risk exposures for each division are reported through the monthly risk and control reports, which provide details of the risk exposures and action plans for each significant business process.

Regulatory risk and supervision

Regulatory risk is the risk arising from failing to meet the requirements of our regulators in the conduct of our business. To mitigate this risk, the Group is active in various regulatory developments affecting risk, capital and liquidity management.

This includes working with domestic and international trade associations, proactively engaging with various regulators, especially the FSA and the main regulatory groups, including the Basel Committee (see page 211), the Committee of European Banking Supervisors, the EU Commission and US regulators.

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

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

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

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

Governance

Board of directors and secretary

Chairman

1. Sir Tom McKillop (age 64)

C, N, R

Appointed to the Board as Deputy Chairman in September 2005, Sir Tom is a non-executive director of BP p.l.c., and president of the Science Council. He was formerly chief executive of AstraZeneca PLC, and was previously president of the European Federation of Pharmaceutical Industries and Associations and chairman of the British Pharma Group. He is Pro-Chancellor of the University of Leicester and a trustee of the Council for Industry and Higher Education.

Executive directors

Group Chief Executive

2. Sir Fred Goodwin (age 48)

DUniv, FCIBS, FCIB, LLD
C

Appointed to the Board in August 1998, Sir Fred is a Chartered Accountant. He was formerly chief executive and director, Clydesdale Bank PLC and Yorkshire Bank PLC. He is chairman of The Prince□s Trust, a non-executive director of Bank of China Limited and a former president of the Chartered Institute of Bankers in Scotland.

Group Finance Director

3. Guy Whittaker (age 50)

C

Appointed to the Board in February 2006, Guy Whittaker was formerly group treasurer at Citigroup Inc., based in New York, having previously held a number of management positions within the financial markets business at Citigroup. He was elected a Lady Beaufort Fellow of Christ's College Cambridge in 2004.

Chief Executive, Corporate Markets
4. Johnny Cameron (age 52) FCIBS
Appointed to the Board in March 2006, Johnny Cameron joined RBS from Dresdner Kleinwort Benson in 1998. In 2000, he was appointed Deputy Chief Executive of Corporate Banking & Financial Markets (CBFM) with responsibility for the integration of the NatWest and RBS Corporate Banking businesses. In October 2001 he was appointed Chief Executive CBFM, subsequently renamed Corporate Markets in January 2006.

Chairman and Chief Executive Officer of Citizens Financial Group, Inc.

5. Lawrence Fish (age 62)

Appointed to the Board in January 1993, Lawrence Fish is an American national. He is a career banker and was previously a director of the Federal Reserve Bank of Boston. He is a trustee of the Massachusetts Institute of Technology (MIT) and The Brookings Institution, and a director of Textron Inc. and numerous community organisations in the USA.

Chief Executive, Manufacturing

6. Mark Fisher (age 46) FCIBS

Appointed to the Board in March 2006, Mark Fisher is a career banker having joined National Westminster Bank Plc in 1981. In 2000, he was appointed Chief Executive, Manufacturing with various responsibilities including the integration of RBS and NatWest systems platforms. He is chairman of APACS Administration Limited.

Chief Executive, Retail Markets

7. Gordon Pell (age 57) FCIBS, FCIB

Appointed to the Board in March 2000, Gordon Pell was formerly group director of Lloyds TSB UK Retail Banking before joining National Westminster Bank Plc as a director in February 2000 and then becoming chief executive, Retail Banking. He is also a director of Race for Opportunity and a member of the National Employment Panel and the FSA Practitioner Panel. He was appointed chairman of the Business Commission on Racial Equality in the Workplace in July 2006.

Non-executive directors

8. Colin Buchan* (age 52)

A, C, R

Appointed to the Board in June 2002, Colin Buchan was educated in South Africa and spent the early part of his career in South Africa and the Far East. He has considerable international investment banking experience, as well as experience in very large risk management in the equities business. He was formerly a member of the group management board of UBS AG and head of equities of UBS Warburg. He is chairman of UBS Securities Canada Inc. and vice-chairman of Standard Life Investments (Holdings) Ltd. He is also a director of Merrill Lynch World Mining Trust Plc, Merrill Lynch Gold Limited, Royal Scottish National Orchestra Society Limited and World Mining Investment Company Limited.

9. Jim Currie* (age 65) D.Litt

R

Appointed to the Board in November 2001, Jim Currie is a highly experienced senior international civil servant who spent many years working in Brussels and Washington. He was formerly director general at the European Commission with responsibility for the EUs environmental policy and director general for Customs and Excise and Indirect Taxation. He is also a director of Total Upstream UK Limited and an international adviser to Eversheds. He is a special adviser to the president of the European Bank for Reconstruction and Development.

10. Bill Friedrich* (age 58)

A

Appointed to the Board in March 2006, Bill Friedrich is currently deputy chief executive of BG Group plc. He previously served as general counsel for British Gas plc and is a former partner of Shearman & Sterling where he practised as a general corporate lawyer working for several of the world's leading financial institutions.

11. Archie Hunter* (age 63)

A (Chairman), C, N

Appointed to the Board in September 2004, Archie Hunter is a Chartered Accountant. He was Scottish senior partner of KPMG between 1992 and 1999 and President of The Institute of Chartered Accountants of Scotland in 1997/1998. He has extensive professional experience in the UK and North and South America. He is currently chairman of Macfarlane Group plc, a director of Edinburgh US Tracker Trust plc, Convenor of Court at the University of Strathclyde and a governor of the Beatson Cancer Research Institute.

12. Charles “Bud” Koch (age 60)

Appointed to the Board in September 2004, Bud Koch is an American national. He has extensive professional experience in the USA and is currently chairman of the board of John Carroll University and a trustee of Case Western Reserve University. He was chairman, president and chief executive officer of Charter One Financial, Inc. and its wholly owned subsidiary, Charter One Bank, N.A. between 1973 and 2004. He is also a director of Assurant, Inc.

13. Janis Kong* (age 56) OBE, DUniv

R

Appointed to the Board in January 2006, Janis Kong was formerly executive chairman of Heathrow Airport Limited, chairman of Heathrow Express Limited and a director of BAA plc. She is currently a non-executive director of Kingfisher plc and Portmeirion Group plc. She is also chairman of Forum for the Future and a member of the board of Visit Britain.

14. Joe MacHale* (age 55)

A

Appointed to the Board in September 2004, Joe MacHale is currently the senior independent director and chairman of the audit committee of Morgan Crucible plc, a non-executive director and chairman of the remuneration committee of Brit Insurance Holdings plc, and a trustee of MacMillan Cancer Support. He held a number of senior executive positions with J P Morgan between 1979 and 2001 and was latterly chief executive of J P Morgan Europe, Middle East and Africa Region.

15. Sir Steve Robson* (age 63)

A

Appointed to the Board in July 2001, Sir Steve is a former senior UK civil servant, who had responsibility for a wide variety of Treasury matters. His early career included the post of private secretary to the Chancellor of the Exchequer and secondment to ICFC (now 3i). He was also a second permanent secretary of HM Treasury, where he was managing director of the Finance and Regulation Directorate. He is a non-executive director of JP Morgan Cazenove Holdings, Xstrata Plc and Partnerships UK plc, and a member of the Chairman’s Advisory Committee of KPMG.

16. Bob Scott* (age 65) CBE, FCIBS

C, N, R (Chairman)

Appointed to the Board in January 2001, Bob Scott is an Australian national. He is the senior independent director. He has many years’ experience in the international insurance business and played a leading role in the consolidation of the UK insurance industry. He is a former group chief executive of CGNU plc (now Aviva plc) and former chairman of the board of the Association of British Insurers. He is chairman of Yell Group plc and a non-executive director of Swiss Reinsurance Company (Zurich) and Jardine Lloyd Thompson Group plc. He is also a trustee of the Crimestoppers Trust, an adviser to Duke Street Capital Private Equity and a board member of

Pension Insurance Corporation Holdings LLP.

17. Peter Sutherland* (age 60) KCMG

C, N, R

Appointed to the Board in January 2001, Peter Sutherland is an Irish national. He is a former attorney general of Ireland and from 1985 to 1989 was the European Commissioner responsible for competition policy. He is chairman of BP p.l.c. and Goldman Sachs International. He was formerly chairman of Allied Irish Bank and director general of GATT and its successor, the World Trade Organisation.

Group Secretary and General Counsel

18. Miller McLean (age 57) FCIBS

C

Miller McLean was appointed Group Secretary in August 1994. He is a trustee of the Industry and Parliament Trust, non-executive chairman of The Whitehall and Industry Group and director of The Scottish Parliament and Business Exchange.

A member of the Audit Committee

C member of the Chairman's Advisory Group

N member of the Nominations Committee

R member of the Remuneration Committee

***** independent non-executive director

63

Report of the directors

The directors have pleasure in presenting their report together with the audited accounts for the year ended 31 December 2006.

Profit and dividends

The profit attributable to the ordinary shareholders of the company for the year ended 31 December 2006 amounted to £6,202 million compared with £5,392 million for the year ended 31 December 2005, as set out in the consolidated income statement on page 101.

An interim dividend of 24.2p per ordinary share was paid on 6 October 2006 totalling £771 million (2005 – £619 million). The directors now recommend that, subject to approval at the Annual General Meeting, a final dividend of 66.4p per ordinary share totalling £2,093 million (2005 – £1,699 million) be paid on 8 June 2007 to members on the register at the close of business on 9 March 2007.

Business review
Activities

The company is a holding company owning the entire issued ordinary share capital of The Royal Bank of Scotland, the principal direct operating subsidiary undertaking of the company. The ‘Group’ comprises the company and all its subsidiary and associated undertakings, including The Royal Bank of Scotland and NatWest. Details of the principal subsidiary undertakings of the company are shown in Note 15 on the accounts.

The Group is engaged principally in providing a wide range of banking, insurance and other financial services. Further details of the organisational structure and business overview of the Group, including the products and services provided by each of its divisions and the competitive markets in which they operate, is contained on pages 4 and 5 of the Operating and financial review.

Risk factors

The Group’s future performance and results could be materially different from expected results depending on the outcome of certain potential risks and uncertainties. Details of the principal risk factors the Group faces are given on page 6 of the Operating and financial review.

The reported results of the Group are also sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. Details of the Group’s critical accounting policies and key sources of accounting judgements are included in the Accounting policies on pages 98 to 100.

The Group’s approach to risk management, including its financial risk management objectives and policies and information on the Group’s exposure to price, credit, liquidity and cash flow risk is discussed in Note 34 on the accounts.

Financial performance

A review of the Group’s performance during the year ended 31 December 2006, including details of each division, and the Group’s financial position as at that date is contained in the Operating and financial review on pages 7 to 38.

Business developments

The Group led a consortium which acquired a 10% stake in Bank of China for US$3.1 billion in 2005. The Group itself invested US$1.6 billion. Bank of China listed on the Hong Kong Stock Exchange in June 2006 and on the Shanghai Stock Exchange in July 2006, issuing new shares equivalent to 14.14% of its enlarged share capital and raising US$13.7 billion. The Group did not take up its rights in the listings and the consortiums shareholding in Bank of China is now 8.25%.

In the year since the RBS investment was completed in December 2005, good progress has been made in developing the partnership. The joint credit card business has already issued more than one million cards and both sides have agreed to expand its scope to include all credit cards and merchant acquiring in mainland China. Preparations have been made to open pilot offices for the joint private banking business in Beijing and Shanghai early in 2007. Co-operation in corporate banking led to the completion of over £1 billion of transactions in shipping, aviation and trade finance. RBS has provided advice in a number of key operational areas including risk management, IT and human resources.

Employees

As at 31 December 2006, the Group employed 135,000 employees (full-time equivalent basis) throughout the world. Details of employee related costs are included in Note 2 on the accounts on page 105.

Employee recruitment

Across the Group, over 20,000 employees are recruited at different levels every year. The Group utilises a wide range of recruitment channels including executive search, general advertising, an open internal jobs market, talent fora and detailed succession planning to ensure that the recruitment and development of its employees are fully aligned to its organisational requirements.

Employee reward

The Groups continuing success is closely linked to the performance, skills and individual commitment of its employees. In order to attract, motivate and retain the best available talent at every level, the Group offers a comprehensive remuneration and benefits package, Total Reward, to all employees.

Within this package, RBS*elect*, the Groups benefit choice programme, provides for UK staff in the Group a flexible way of tailoring their reward to reflect their own individual lifestyles. During 2006, the Group brought retirement savings provision within RBS*elect* in order to provide more choice for the receipt of retirement benefits. Employees can also participate in bonus incentive plans specific to their business and share in the Groups ongoing success through profit sharing, Buy As You Earn and Sharesave schemes, which align their interests with those of shareholders.

Report of the directors continued

Employee learning and development

The Group maintains a strong commitment to creating and providing learning opportunities for all its employees through a variety of personal development and training programmes and learning networks. The Groups employees are encouraged to volunteer to work with its community partners. The Group continues to invest in leadership and management development which is consistent with its objective of being the employer of choice: attracting, rewarding and retaining the very best talent.

Many of the Groups development programmes are delivered at the RBS Business School, based on the Gogarburn Campus.

Employee communication

Employee engagement is encouraged through a variety of means including the corporate intranet, Group and divisional magazines, team meetings led by line managers, briefings held by senior managers and regular dialogue with employees and employee representatives. The Group Chief Executive and other senior Group executives regularly communicate with employees through Question Time style programmes, broadcast on the Groups internal television network.

Employee consultation

The Groups confidential global employee opinion survey is externally designed, undertaken and analysed annually on behalf of the Group by International Survey Research (ISR). The survey enables employees to maximise their contribution to the Group by expressing their views and opinions on a range of key issues.

A record-breaking 87% of Group employees in over 30 countries completed the 2006 survey. For the second year in a row, the Group scored significantly above the ISR Global Financial Services Norm in all categories. The survey results are presented to the Board and at divisional and team levels. Action plans are developed to address any issues identified.

The Group recognises trade unions in the UK and Ireland. These formal relationships are complemented by works council arrangements in many of the Groups mainland Europe-based operations. The Group has a European Employee Communication Council that provides elected employee representatives with an opportunity to better understand the impact on its European operations.

Diversity

The Groups Managing Diversity policy sets a framework for broadening the Groups talent base, achieving the highest levels of performance, and enabling all employees to reach their full potential irrespective of age, disability, gender, marital status, political opinion, race, religious belief or sexual orientation.

The Group is also committed to ensuring that all prospective applicants for employment are treated fairly and equitably throughout the recruitment process. Its comprehensive resourcing standards cover the attraction and retention of individuals with disabilities. Reasonable adjustments are provided to support applicants in the recruitment process where these are required. The Group provides reasonable workplace adjustments for new entrants into the Group and for existing employees who become disabled during their employment.

Health, safety, wellbeing and security

The health, safety, wellbeing and security of employees and customers continues to be a priority for the Group. Regular reviews are undertaken of both policies and processes to ensure compliance with current legislation and best practice. The Group focus is on ensuring that these policies are closely linked to the operational needs of the business.

In the first quarter of 2006 the Group launched a Wellbeing website which includes a health and wellbeing calendar. The site is designed to raise awareness of international health issues and events, and to provide lifestyle education, information and support to employees.

Services were extended under HelpDirect, the Group's Employee Assistance Programme, to provide support to all employees in the event of a critical incident. The service provides telephone access to qualified clinicians and a global network of counselling affiliates to enable the Group to provide a consistent level of support to individuals and the business wherever they are located.

Code of ethics

The Group has adopted a code of ethics that is applicable to all of the Group's employees and a copy is available upon request.

Corporate responsibility

Business excellence requires that the Group meets changing customer, shareholder, investor, employee and supplier expectations. The Group believes that meeting high standards of environmental, social and ethical responsibility is key to the way it does business.

For the financial services sector, consumer banking issues are the primary focus, followed by financial inclusion and capability, financial crime and corruption, employee practices, the challenge of climate change, support for small businesses and community giving. The Group takes all these responsibilities seriously, continually monitoring and managing them through policies and practices across the Group. The Board regularly considers corporate responsibility issues and receives a formal report on these twice each year.

Further details of the Group's corporate responsibility policies will be contained in the 2006 Corporate Responsibility Report.

Going concern

The directors are satisfied that the Group has adequate resources to continue in business for the foreseeable future. For this reason, they continue to adopt the 'going concern' basis for preparing the accounts.

Corporate governance

The company is committed to high standards of corporate governance. Details are given on pages 68 to 75.

Report of the directors continued

Ordinary share capital

During the year ended 31 December 2006, the company purchased for cancellation 54.4 million of its ordinary shares at a total cost of £1 billion. These repurchases represented 1.7% of the issued ordinary share capital of the company at 31 December 2006.

During the year, the ordinary share capital was increased by 7.5 million ordinary shares allotted as a result of the exercise of options under the company's executive and sharesave schemes, 0.3 million ordinary shares allotted in respect of the exercise of options under the NatWest executive scheme which had been exchanged for options over the company's ordinary shares following the acquisition of NatWest in 2000 and 2.2 million ordinary shares allotted under the company's employee share ownership plan.

Details of the authorised and issued ordinary share capital at 31 December 2006 are shown in Note 30 on the accounts.

Preference share capital

Details of issues and redemptions of preference shares during the year and the authorised and issued preference share capital at 31 December 2006 are shown in Note 30 on the accounts.

Authority to repurchase shares

At the Annual General Meeting in 2006, shareholders renewed the authority for the company to make market purchases of up to 319,778,520 ordinary shares. As at 28 February 2007 (the latest practical date prior to printing of this report) the company had an unexpired authority to repurchase further shares up to a maximum of 265,384,899 ordinary shares of 25p. Shareholders will be asked to renew this authority at the Annual General Meeting in April 2007.

Bonus issue

Shareholders will be asked to vote at the Annual General Meeting on a proposal for the capitalisation of part of the company's share premium account, resulting in the issue of up to 6.4 billion new ordinary shares of 25p each, details of which are set out in the letter to shareholders.

Directors

The names and brief biographical details of the directors are shown on pages 62 and 63. All directors, except:

- Fred Watt, who resigned from the Board on 31 January 2006,
- Guy Whittaker, who was appointed to the Board on 1 February 2006,
- Johnny Cameron, Mark Fisher and Bill Friedrich, who were appointed to the Board on 1 March 2006, and
- Sir George Mathewson, who retired from the Board on 28 April 2006,

served throughout the year and to the date of signing of the financial statements.

Lawrence Fish, Sir Fred Goodwin, Archie Hunter, Bud Koch, Joe MacHale and Gordon Pell will retire and offer themselves for re-election at the company's Annual General Meeting.

Details of the service agreements for Lawrence Fish, Sir Fred Goodwin and Gordon Pell are set out on pages 79 and 80. No other director seeking election or re-election has a service agreement.

Directors' interests

The interests of the directors in the shares of the company at 31 December 2006 are shown on page 87. None of the directors held an interest in the loan capital of the company or in the shares and loan capital of any of the subsidiary undertakings of the company, during the period from 1 January 2006 to 28 February 2007.

Directors' indemnities

In terms of section 309C of the Companies Act 1985 (as amended), the directors of the company, members of the Group Executive Management Committee and Approved Persons of the Group (under the Financial Services and Markets Act 2000) have been granted Qualifying Third Party Indemnity Provisions by the company.

Directors' disclosure to auditors:

Each of the directors at the date of approval of this report confirms that:

(a) so far as the director is aware, there is no relevant audit information of which the company's auditors are unaware; and

(b) the director has taken all the steps that he/she ought to have taken as a director to make himself/herself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 234ZA of the Companies Act 1985.

Shareholdings

As at 28 February 2007, the company had been notified of the following interests in its shares.

	Number of shares	% held		Number of shares	% held
Ordinary shares:			$5^{1}/2$ % cumulative preference shares:		
Legal & General Group plc	127,207,908	4.01	Commercial Union Assurance plc	91,429	22.86
Barclays PLC	126,836,868	4.01	Mr P. S. and Mrs J. Allen	86,999	21.75
The Capital Group of Companies, Inc	95,578,555	3.01	Bassett-Patrick Securities Limited*	46,255	11.56
11% cumulative preference shares:			E M Behrens Charitable Trust	20,000	5.00
Guardian Royal Exchange			Mrs Gina Wild	19,800	4.95
Assurance plc	129,830	25.97	Trustees of The Stephen Cockburn		
Windsor Life Assurance			Limited Pension Scheme	19,879	4.97
Company Limited	51,510	10.30	Miss Elizabeth Hill	16,124	4.03
Mr S. J. and Mrs J. A. Cockburn	30,810	6.16	Mr W. T. Hardison Jr.	13,532	3.38
Cleaning Tokens Limited	25,500	5.10	Ms C. L. Allen	13,200	3.30
			Ms J. C. Allen	12,750	3.18

* Notification has been received on behalf of Mr A. W. R. Medlock and Mrs H. M. Medlock that they each have an interest in the holding of $5^{1}/2$ % cumulative preference shares registered in the name of Bassett-Patrick Securities Limited noted above and that there are further holdings of 5,300 and 5,000 shares, respectively, of that class registered in each of their names.

Charitable contributions

In 2006 the contribution to the Group's Community Investment programmes increased to £58.6 million (2005 – £56.2 million). The total amount given for charitable purposes by the company and its subsidiary undertakings during the year ended 31 December 2006 was £25.4 million (2005 – £24.3 million).

Political donations

At the Annual General Meeting in 2006, shareholders gave authority for the company to make political donations and incur political expenditure up to a maximum aggregate sum of £500,000 as a precautionary measure in light of the wide definitions in The Political Parties, Elections and Referendums Act 2000, for a period of four years. These authorities have not been used.

No political donations were made during the year and it is not proposed that the Group's longstanding policy of not making contributions to any political party be changed.

Policy and practice on payment of creditors

The Group is committed to maintaining a sound commercial relationship with its suppliers. Consequently, it is the Group's policy to negotiate and agree terms and conditions with its suppliers, which includes the giving of an undertaking to pay suppliers within 30 days of receipt of a correctly prepared invoice submitted in accordance with the terms of the contract or such other payment period as may be agreed.

At 31 December 2006, the Group's trade creditors represented 28 days (2005 – 27 days) of amounts invoiced by suppliers. The company does not have any trade creditors.

Auditors

The auditors, Deloitte & Touche LLP, have indicated their willingness to continue in office. A resolution to re-appoint Deloitte & Touche LLP as the company's auditor will be proposed at the forthcoming Annual General

Meeting.

By order of the Board.

Miller McLean
Secretary
28 February 2007

The Royal Bank of Scotland Group plc
is registered in Scotland No. 45551.

Corporate governance

The company is committed to high standards of corporate governance, business integrity and professionalism in all its activities.

Throughout the year ended 31 December 2006, the company has complied with all of the provisions of the Combined Code issued by the Financial Reporting Council (the FRC) in July 2003 (the Code) except in relation to the authority reserved to the Board to make the final determination of the remuneration of the executive directors and in relation to the appointment of the Chairman of the Board to the Remuneration Committee, which are explained in the paragraph headed Remuneration Committee.

The company has also complied with the Smith Guidance on Audit Committees in all material respects.

Under the US Sarbanes-Oxley Act of 2002 (the Act), specific standards of corporate governance and business and financial disclosures apply to companies, including the company, with securities registered in the US. Section 404 of the Act concerns internal control over financial reporting and the Group is required to comply with it for the first time for the financial year ended 31 December 2006. The company complies with section 404 and all other applicable sections of the Act.

Board of directors

The Board is the principal decision-making forum for the company. It has overall responsibility for leading and controlling the company and is accountable to shareholders for financial and operational performance. The Board approves Group strategy and monitors performance. The Board has adopted a formal schedule of matters detailing key aspects of the companys affairs reserved to it for its decision. This schedule is reviewed annually.

The roles of the Chairman and Group Chief Executive are distinct and separate, with a clear division of responsibilities. The Chairman leads the Board and ensures the effective engagement and contribution of all non-executive and executive directors. The Group Chief Executive has responsibility for all Group businesses and acts in accordance with the authority delegated by the Board. Responsibility for the development of policy and strategy and operational management is delegated to the Group Chief Executive and other executive directors.

All directors participate in discussing strategy, performance and the financial and risk management of the company. Meetings of the Board are structured to allow open discussion.

The Board met nine times during 2006 and was supplied with comprehensive papers in advance of each Board meeting covering the Groups principal business activities. Members of executive management attend and make regular presentations at meetings of the Board.

The Board is aware of the other commitments of its directors and is satisfied that these do not conflict with their duties as non-executive directors of the company.

Board balance and independence

The Board currently comprises the Chairman, six executive directors and ten non-executive directors. The Board functions effectively and efficiently, and is considered to be of an appropriate size in view of the scale of the company and the diversity of its businesses. The directors provide the Group with the knowledge, mix of skills, experience and networks of contacts required. The Board Committees contain directors with a variety of relevant skills and experience so that no undue reliance is placed on any individual.

The non-executive directors combine broad business and commercial experience with independent and objective judgement. The balance between non-executive and executive directors enables the Board to provide clear and effective leadership and maintain the highest standards of integrity across the companys business activities. The names and biographies of all Board members are set out on pages 62 and 63.

The composition of the Board is subject to continuing review and the provisions of the Code will be taken into account in respect of the balance of the Board. The Code requires the Board to determine whether its non-executive members are independent.

The Board comprises nine independent and seven non-independent directors (including executive directors), in addition to the Chairman. Bob Scott has been nominated as the senior independent director.

The Board considers that all non-executive directors are independent for the purposes of the Code, with the exception of Bud Koch who was formerly Chairman, President and Chief Executive Officer of Charter One Financial, Inc. which was acquired by Citizens Financial Group, Inc. in 2004.

Re-election of directors

At each Annual General Meeting, one third of the directors retire and offer themselves for re-election and each director must stand for re-election at least once every three years. Any non-executive directors who have served for more than nine years will also stand for annual re-election and the Board will consider their independence at that time. The proposed reelection of directors is subject to prior review by the Board.

The names of directors standing for re-election at the 2007 Annual General Meeting are contained on page 66 and further information will be given in the Chairman's letter to shareholders in relation to the company's Annual General Meeting.

Information, induction and professional development

All directors receive accurate, timely and clear information on all relevant matters. All directors have access to the advice and services of the Group Secretary who is responsible to the Board for ensuring that Board procedures are followed and that applicable rules and regulations are complied with. In addition, all directors are able, if necessary, to obtain independent professional advice at the company's expense.

Each new director receives a formal induction on joining the Board, including visits to the Group's major businesses and meetings with directors and senior management. The induction is tailored to the director's specific requirements. Directors are advised of appropriate training and professional development opportunities and undertake training and professional development they consider necessary in assisting them to carry out their duties as a director.

Performance evaluation

The Board has undertaken a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

The performance evaluation of the operation and effectiveness of the Board, the Remuneration Committee and the Nominations Committee was undertaken in the autumn of 2006. This was conducted internally using a detailed questionnaire and individual meetings with each director. Amongst the areas reviewed were the role of the Board, Board composition, Board meetings and processes, Board performance and reporting, external relationships and Board Committees. A separate performance evaluation of the Audit Committee was also undertaken internally in late 2006 using a detailed questionnaire and meetings with Audit Committee members and attendees.

The report on the Board evaluation, which was designed to assist the Board in further improving its performance, was considered and discussed by the Board as a whole and a separate report on the outcomes of the evaluation of the Audit Committee was also considered and discussed by the Board. Careful consideration was given by all directors to the composition of the Board to assist the Nominations Committee in its future planning. The Board also considered the range and balance of its activities and was content that it was allocating appropriate time to such key matters as monitoring business performance, risk appetite and strategy.

Taking into account their review and deliberations the directors have concluded that the Board is effective in meeting its objectives and fulfilling its duties and obligations. The directors are also satisfied that each of the Board's Committees (Audit, Remuneration and Nominations) carries out its delegated duties effectively.

In addition, each director discussed his or her own performance as a director and their Board evaluation with the Chairman. The senior independent director canvassed the views of the executive directors and met with the non-executive directors as a group without the Chairman present to consider the Chairman's performance. The Board is satisfied that each director continues to contribute effectively to the Board and the Group and demonstrates commitment to his or her role as a director.

Board Committees

In order to provide effective oversight and leadership, the Board has established a number of Board Committees with particular responsibilities. The Committee chairmanship and membership are reviewed on a regular basis. The names and biographies of all Board Committee members are set out on pages 62 and 63.

The terms of reference of the Audit, Remuneration and Nominations Committees and the standard terms and conditions of appointment of non-executive directors are available on the Group's website (www.rbs.com) and copies are available on request.

Audit Committee

All members of the Audit Committee are independent non-executive directors. The Audit Committee holds at least five meetings each year. The Audit Committee's report is set out on pages 74 and 75.

Remuneration Committee

The members of the Remuneration Committee comprise independent non-executive directors together with the Chairman of the Board. In June 2006, the FRC issued a revised Combined Code (the "revised Code") which applies to reporting years beginning on or after 1 November 2006. The company has adopted provision B.2.1. of the revised Code early and appointed the Chairman of the Board as a member of the Remuneration Committee as the company considers him to have been independent on appointment as Chairman. In that regard the provisions of the Code have not been complied with. The Remuneration Committee holds at least three meetings each year.

The Remuneration Comittee is responsible for assisting the Board in discharging its responsibilities and making all relevant disclosures in relation to the formulation and review of the Group's executive remuneration policy. The Remuneration Committee makes recommendations to the Board on the remuneration arrangements for the executive directors, the Chairman and the non-executive directors. In addition, the Remuneration Committee reviews the Group's employee share schemes and is responsible for appointing any remumeration consultants who advise the Remuneration Committee. The Directors' Remuneration Report is contained on pages 76 to 86.

Responsibility for determining the remuneration of executive directors has not been delegated to the Remuneration Committee, and in that sense the provisions of the Code have not been complied with. The Board as a whole reserves the authority to make the final determination of the remuneration of directors as it considers that this two stage process allows greater consideration and evaluation and is consistent with the unitary nature of the Board. No director is involved in decisions regarding his or her own remuneration.

Nominations Committee

The Nominations Committee comprises independent non-executive directors, under the chairmanship of the Chairman of the Board. The Nominations Committee meets as required.

The Nominations Committee is responsible for assisting the Board in the formal selection and appointment of directors. It considers potential candidates and recommends appointments of new directors to the Board. The appointments are based on merit and against objective criteria, including the time available to, and the commitment which will be required of, the potential director.

In addition, the Nominations Committee considers succession planning for the Chairman, Group Chief Executive and non-executive directors. The Nominations Committee takes into account the knowledge, mix of skills, experience and networks of contacts which are anticipated to be needed on the Board in the future. The Chairman, Group Chief Executive and non-executive directors meet to consider executive succession planning. No director is involved in decisions regarding his or her own succession.

Corporate governance continued

Meetings

The number of meetings of the Board and the Audit, Remuneration and Nominations Committees and individual attendance by members is shown below.

	Board	Audit	Remuneration	Nominations
Total number of meetings in 2006	9	8	5	2
Number of meetings attended in 2006				
Sir George Mathewson (1)	4	—	—	—
Sir Tom McKillop (2)	9	—	2	2
Sir Fred Goodwin	9	—	—	—
Mr Buchan	9	8	5	—
Mr Cameron (3)	7	—	—	—
Dr Currie	9	—	5	—
Mr Fish	8	—	—	—
Mr Fisher (3)	7	—	—	—
Mr Friedrich (4)	6	2	—	—
Mr Hunter (5)	9	8	—	1
Mr Koch	8	—	—	—
Mrs Kong (6)	9	—	3	—
Mr MacHale	8	8	—	—
Mr Pell	9	—	—	—
Sir Steve Robson	7	7	—	—
Mr Scott	9	—	5	2

Mr Sutherland (6)	8		2	2
Mr Watt (7)	1			
Mr Whittaker (8)	8			

Notes:

(1) Sir George Mathewson retired from the Board on 28 April 2006.

(2) Sir Tom McKillop was appointed to the Remuneration Committee on 27 September 2006.

(3) Mr Cameron and Mr Fisher were appointed to the Board on 1 March 2006.

(4) Mr Friedrich was appointed to the Board on 1 March 2006 and to the Audit Committee on 1 July 2006.

(5) Mr Hunter was appointed to the Nominations Committee on 1 July 2006.

(6) Mrs Kong and Mr Sutherland were appointed to the Remuneration Committee on 1 July 2006.

(7) Mr Watt resigned from the Board on 31 January 2006.

(8) Mr Whittaker was appointed to the Board on 1 February 2006.

Relations with shareholders

The company communicates with shareholders through the Annual Report and by providing information in advance of the Annual General Meeting. Individual shareholders can raise matters relating to their shareholdings and the business of the Group at any time throughout the year. Shareholders are given the opportunity to ask questions at the Annual General Meeting or submit written questions in advance. The chairmen of the Audit, Remuneration and Nominations Committees are available to answer questions at the Annual General Meeting.

Communication with the companys largest institutional shareholders is undertaken as part of the companys investor relations programme. During the year, the directors received copies of analysts reports and a monthly report from the Groups investor relations department which includes an analysis of share price movements, the Groups performance against the sector, and key broker comments. In addition, information on major investor relations activities and changes to external ratings is provided. The senior independent director would be available to shareholders if concerns could not be addressed through the normal channels. The arrangements used to ensure that directors develop an understanding of the views of major shareholders are considered as part of the annual Board performance evaluation.

The Chairman, Group Chief Executive, Group Finance Director and, if appropriate, the senior independent director communicate shareholder views to the Board as a whole.

The Board commissions a survey of investor perceptions annually. The survey is undertaken on behalf of the Board by independent consultants and the outcomes of the study are considered by the Board.

Internal control

Management of The Royal Bank of Scotland Group (referred to in this and the immediately following sub-section as the "Group") is responsible for the Groups system of internal control that is designed to facilitate effective and efficient operations and to ensure the quality of internal and external reporting and compliance with applicable laws and regulations. In devising internal controls, the Group has regard to the nature and extent of the risk, the likelihood of it crystallising and the cost of controls. A system of internal control is designed to manage, but not eliminate, the risk of failure to achieve business objectives and can only provide reasonable, and not absolute, assurance against the risk of material misstatement, fraud or losses.

Managements report on internal control over financial reporting

Internal control over financial reporting is a component of an overall system of internal control. The Groups internal control over financial reporting is a process designed to provide reasonable assurance regarding the preparation and fair presentation of financial statements for external purposes, in accordance with International Financial Reporting Standards (IFRS) and US generally accepted accounting principles, collectively referred to as GAAP.

The Groups internal control over financial reporting includes:

- Processes designed to provide assurance regarding the reliability of financial reporting and financial statements in accordance with GAAP.
- Policies and procedures that relate to the maintenance of records that fairly and accurately reflect the transactions and disposition of assets.
- Controls providing reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in accordance with GAAP, and that receipts and expenditures are being made only as authorised by management.
- Controls providing reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use or disposition of assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or because the degree of compliance with policies or procedures may deteriorate.

Management assessed the effectiveness of the Groups internal control over financial reporting as of 31 December 2006 based on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on this assessment, Management believes that, as of 31 December 2006, the Groups internal control over financial reporting is effective.

The assessment of the effectiveness of the Group's internal control over financial reporting as of 31 December 2006 has been audited by Deloitte & Touche LLP, the Group's independent registered public accountants. The report of independent registered public accounting firm to the directors of The Royal Bank of Scotland Group plc expresses unqualified opinions on the assessment and on the effectiveness of the Group's internal control over financial reporting as of 31 December 2006.

Disclosure controls and procedures

As required by US regulations, the effectiveness of the companys disclosure controls and procedures (as defined in the rules under the US Securities Exchange Act of 1934) have been evaluated. This evaluation has been considered and approved by the Board which has instructed the Group Chief Executive and the Group Finance Director to certify that as at 31 December 2006, the companys disclosure controls and procedures were adequate and effective and designed to ensure that material information relating to the company and its consolidated subsidiaries would be made known to them by others within those entities.

Changes in internal controls

There was no change in the company's internal control over financial reporting that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Report of Independent Registered Public Accounting Firm to the directors of The Royal Bank of Scotland Group plc

We have audited management s assessment, included in Management s report on Internal control over financial reporting , that The Royal Bank of Scotland Group plc and subsidiaries (the Group) maintained effective internal control over financial reporting as at 31 December 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Group's management are responsible for maintaining effective internal control over financial reporting and for the assessment of its effectiveness. Our responsibility is to express opinions on management's assessment and the effectiveness of the Group's internal control over financial reporting.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that the Group maintained effective internal control over financial reporting as at 31 December 2006 is fairly stated, in all material respects, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Group maintained, in all material respects, effective internal control over financial reporting as at 31 December 2006, based on the criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of the Group as at and for the year ended 31 December 2006 and our report dated 28 February 2007 expressed an unqualified opinion on those financial statements and includes an explanatory paragraph relating to the nature and effect of differences between International Financial Reporting Standards and accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP
Chartered Accountants and Registered Auditors

Edinburgh, United Kingdom
28 February 2007

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Corporate governance continued

Audit Committee Report

The members of the Audit Committee are Archie Hunter (Chairman), Colin Buchan, Bill Friedrich (since July 2006), Joe MacHale and Sir Steve Robson. All members of the Audit Committee are independent non-executive directors. The Audit Committee holds at least five meetings each year, two of which are held immediately prior to submission of the interim and annual financial statements to the Group Board. This core agenda is supplemented by additional meetings as required, three being added in 2006. Audit Committee meetings are attended by relevant executive directors, the internal and external auditors and finance and risk management executives. At least twice per annum the Audit Committee meets privately with the external auditors. The Audit Committee also visits business divisions and selected Group functions under a programme set at the beginning of each year.

The Board is satisfied that all the Audit Committee members have recent and relevant financial experience. Although the Board has determined that each member of the Audit Committee is an "Audit Committee Financial Expert" and is independent, each as defined in the SEC rules under the US Securities Exchange Act of 1934 and related guidance, the members of the Audit Committee are selected with a view to the expertise and experience of the Audit Committee as a whole, and the Audit Committee reports to the Board as a single entity. The designation of a director or directors as an "Audit Committee Financial Expert" does not impose on any such director, any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such director as a member of the Audit Committee and Board in the absence of such a designation. Nor does the designation of a director as an "Audit Committee Financial Expert" affect the duties, obligations or liability of any other member of the Board.

The Audit Committee is responsible for:

- assisting the Board in discharging its responsibilities and in making all relevant disclosures in relation to the financial affairs of the Group;
- reviewing accounting and financial reporting and regulatory compliance;
- reviewing the Group's systems of internal control; and
- monitoring the Group's processes for internal audit, risk management and external audit.

Full details of the responsibilities of the Audit Committee are available at www.rbs.com

The Audit Committee has adopted a policy on the engagement of the external auditors to supply audit and non-audit services, which takes into account relevant legislation regarding the provision of such services by an external audit firm. The Audit Committee reviews the policy annually and prospectively approves the provision of audit services and certain non-audit services by the external auditors.

Annual audit services include all services detailed in the annual engagement letter including the annual audit and interim reviews (including US reporting requirements), periodic profit verifications and reports to regulators including skilled persons reports commissioned by the Financial Services Authority (e.g. Reporting Accountants Reports).

Annual audit services also include statutory or non-statutory audits required by any Group companies that are not incorporated in the United Kingdom. Terms of engagement for these audits are agreed separately with management, and are consistent with those set out in the audit engagement letter, as local regulations permit.

The prospectively approved non-audit services include the following classes of service:

- capital raising, including consents, comfort letters and relevant reviews of registration statements;
- provision of accounting opinions relating to the financial statements of the Group;
- provision of reports that, according to law or regulation, must be rendered by the external auditors;
- tax compliance services;
- corporate finance services relative to companies that will remain outside the Group; and
- insolvency work relating to the Group's customers.

The Audit Committee, in advance of the commencement of any such service, approves all other permitted non-audit services on a case by case basis. In addition, the Audit Committee reviews and monitors the independence and objectivity of the external auditors when it approves non-audit work to be carried out by them, taking into consideration relevant legislation and ethical guidance. Information on the audit and non-audit services carried out by the external auditors is detailed in Note 4 to the Group's accounts.

The Audit Committee undertakes an annual evaluation to assess the independence and objectivity of the external auditors and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements. The results of this evaluation are reported to the Board.

The Audit Committee is responsible for making recommendations to the Board, for it to put the Audit Committee's recommendations to shareholders for their approval at the Annual General Meeting in relation to the appointment, reappointment and removal of the external auditors. The Board has endorsed the Audit Committee's recommendation that shareholders be requested to approve the reappointment of Deloitte & Touche LLP as external auditors at the Annual General Meeting in April 2007.

The Audit Committee also fixes the remuneration of the external auditors as authorised by shareholders at the Annual General Meeting.

The Audit Committee approves the terms of engagement of the external auditors.

In 2004 KPMG conducted a review of the effectiveness of Group Internal Audit. It is intended that there will be an external review of the effectiveness of Group Internal Audit every three to five years in line with best practice, with internal reviews continuing in the intervening years. In 2006 the Audit Committee conducted a review of Group Internal Audit that involved cross Group participation and the external auditors and concluded that the function operated effectively. The Board also concluded, following the 2006 internal review, that the Group Internal Audit function was effective. During 2005 PricewaterhouseCoopers conducted an external review of the effectiveness of the Audit Committee, the results of which were reported to the Board. It is intended that there will be an external review of the effectiveness of the Audit Committee every three years, with internal reviews by the Board continuing in the intervening years. An internal review of the Audit Committee's performance was undertaken in 2006 and a separate report on the outcome was considered and discussed by the Board.

In 2005 the Audit Committee reviewed the audit committee structure throughout the Group and, as a result, proposed to the Board a reorganisation and strengthening of the structure to ensure that audit committees would cover each separate Group business appropriately. That recommendation was accepted by the Board, and, whilst still in its initial year, the revised structure has bedded down well. The Audit Committee has an appropriately close relationship with each of the business audit committees.

Archie Hunter
Chairman of the Audit Committee
28 February 2007

Directors remuneration report

The Remuneration Committee

The members of the Remuneration Committee are Bob Scott (Chairman), Colin Buchan, Jim Currie, Janis Kong, Sir Tom McKillop and Peter Sutherland. The members of the Remuneration Committee comprise independent non-executive directors, together with the Chairman of the Board.

During the year, the Remuneration Committee received advice from Watson Wyatt and Mercer Human Resource Consulting on matters relating to directors remuneration in the UK (Watson Wyatt) and US (Mercer), together with advice from the Group Director, Human Resources and the Group Secretary and General Counsel on general remuneration matters. In addition, the Remuneration Committee has taken account of the views of the Chairman of the Board (who was appointed as a member of the Remuneration Committee in September 2006) and the Group Chief Executive on performance assessment of the executive directors.

In addition to advising the Remuneration Committee, Watson Wyatt provided professional services in the ordinary course of business, including actuarial advice and benefits administration services to subsidiaries of the Group and investment consulting and actuarial advice to the trustees of some of the Groups pension funds. Mercer Human Resource Consulting provided advice and support in connection with a range of benefits, pension actuarial and investment matters.

Remuneration policy

The Remuneration Committee conducted a comprehensive review of all aspects of the remuneration package in 2005, and the executive remuneration policy outcome was approved by shareholders at the companys Annual General Meeting in 2006. During the year, the Remuneration Committee continued to review policy in light of market changes and shareholder comments. As a result, a new executive share option plan is being submitted to shareholders for approval at the companys 2007 Annual General Meeting.

The objective of the executive remuneration policy is to provide, in the context of the companys business strategy, remuneration in form and amount which will attract, motivate and retain high-calibre executives. In order to achieve this objective, the policy is framed around the following core principles:

- Total rewards will be set at levels that are competitive within the relevant market, taking each executive directors remuneration package as a whole. The relevant market is FTSE top 20 companies and major UK banks for the UK- based executives and US retail banks for US-based executives.
- Total potential rewards will be earned through achievement of demanding performance targets based on measures consistent with shareholder interests over the short, medium and longer term.
- Remuneration arrangements will strike an appropriate balance between fixed and performance-related rewards. Performance- related elements will comprise the major part of executive remuneration packages. See illustrative charts below.
- Incentive plans and performance metrics will be structured to be robust through the business cycle.
- Remuneration arrangements will be designed to support the companys business strategy, to promote appropriate teamwork and to conform to best practice standards.

The above diagram has been prepared to illustrate the use of performance metrics in the total direct compensation package. For the Group Chief Executive, 21.5% of the package is fixed and 78.5% is performance related. For the executive directors, 27% is fixed and 73% is performance related. Values are entered on the basis of on-target annual performance; long term incentives are shown at the approximate expected value at grant. Pension and other benefits have been excluded. Financial metrics include profit growth, cost control and ROE.

The non-executive directors fees are reviewed annually by the Board, on the recommendation of its Chairman. The level of remuneration reflects the responsibility and time commitment of directors and the level of fees paid to non-executive directors of comparable major UK companies. Non-executive directors do not participate in any incentive or performance plan.

The Remuneration Committee makes recommendations to the Board on the remuneration arrangements for the executive directors and the Chairman. The Remuneration Committee also approves the remuneration arrangements of senior executives below Board level who are members of the Group Executive Management Committee, on the recommendation of the Group Chief Executive, and reviews all long-term incentive arrangements which are operated by the Group.

Components of executive remuneration
UK based directors
Salary

Salaries are reviewed annually as part of total remuneration, having regard to remuneration packages received by executives of comparable companies. The Remuneration Committee uses a range of survey data from remuneration consultants and reaches individual salary decisions taking account of the remuneration environment and the performance and responsibilities of the individual director.

Benefits

UK-based executive directors, with the exception of Guy Whittaker, are members of The Royal Bank of Scotland Group Pension Fund (the RBS Fund). Any new executive directors will not be eligible to participate in the RBS Fund unless they were already a member prior to 1 October 2006.

The RBS Fund is a non-contributory defined benefit fund. Details of pension arrangements of directors are shown on page 86.

From April 2006, new tax legislation applies to UK pensions. The Remuneration Committee reviewed the pension provision for all executives and determined that the cost of any additional tax that individuals may incur as a result of their benefits exceeding the new lifetime allowances and annual allowances would not be met by the Group. The Committee believes that pension is an effective element in the retention of directors and decided that no changes should be made to existing arrangements other than to allow directors to opt out of future tax-registered pension provision. For those directors who have opted out of the pension provision, the cash allowances are shown on page 81.

Executive directors are eligible to receive a choice of various employee benefits or a cash equivalent, on a similar basis to other employees. In addition, as employees, executive directors are eligible also to participate in Sharesave, Buy As You Earn and the Profit Sharing scheme, which currently pays up to 10 per cent of salaries, depending on the Group's performance. These schemes are not subject to performance conditions since they are operated on an all-employee basis. Executive directors also receive death-in-service benefits.

Short-term annual incentives

UK-based executive directors normally have a maximum annual incentive potential of between 160% and 200% of salary. For exceptional performance, as measured by the achievement of significant objectives, executive directors may be awarded incentive payments of up to 200% of salary, or 250% of salary, in the case of the Group Chief Executive and the Chief Executive, Corporate Markets. Awards will normally be based on the delivery of a combination of appropriate Group and individual financial and operational targets approved each year by the Remuneration Committee.

For the Group Chief Executive, the annual incentive is primarily based on specific Group financial performance measures such as operating profit, earnings per share growth and return on equity. The remainder of the Group Chief Executive's annual incentive is based on a range of non-financial measures which may include measures relating to shareholders, customers and staff.

For the other executive directors a proportion of the annual incentive is based on Group financial performance and a proportion on division financial performance. The remainder of each individual's annual incentive opportunity is dependent on achievement of a range of non-financial measures, specific objectives and key result areas. Divisional performance includes measures such as operating income, costs, loan impairments or operating profit. Non-financial measures include customer measures (e.g. customer numbers, customer satisfaction), staff measures (e.g. employee engagement) and efficiency and change objectives.

In respect of 2006, the Remuneration Committee reviewed the annual incentive payments for all executive directors taking into account performance against the various targets set at the beginning of the year and covering overall Group financial metrics, divisional performance and each director's other operational targets.

Group operating profit and other Group financial metrics were fully met or exceeded, while most divisional and individual performance objectives were also met or exceeded. As a result, the Remuneration Committee proposed and the Board (excluding executive directors) agreed annual incentive payments ranging from 75% to 125% of normal maximum level. The payments made to Mr Cameron (125% of normal maximum) and Sir Fred Goodwin (110% of normal maximum) reflected the outstanding performance achieved by Corporate Markets and the Group overall respectively and were within the exceptional maximum level.

Long-term incentives

The company provides long-term incentives in the form of share options and share or share equivalent awards. Their objective is to encourage the creation of value over the long term and to align the rewards of the executive directors with the returns to shareholders.

Medium-term Performance Plan

The Medium-term Performance Plan (MPP) was approved by shareholders in April 2001. Each executive director is eligible for an annual award under the plan in the form of share or share equivalent awards. Whilst the rules of the plan allow awards over shares worth up to one and a half times earnings, the Remuneration Committee has adopted a policy of granting awards based on a multiple of salary. Normally awards are made at one times salary to executive directors, with one and a half times salary being granted in the case of the Group Chief Executive. No changes will be made to this policy without prior consultation with shareholders. All awards under the plan are subject to three-year performance targets.

Awards made from 2006 are subject to two performance measures; 50% of the award vests on a relative Total Shareholder Return (TSR) measure and 50% vests on growth in adjusted earnings per share (EPS) over the three year performance period.

For the TSR element, vesting is based on the level of outperformance by the Group of the median of the comparator group TSR over the performance period. Awards made under the plan will not vest if the company's TSR is below the median of the comparator group. Achievement of median TSR performance against comparator companies will result in vesting of 25% of the award. Outperformance of median TSR performance by up to 9% will result in vesting on a straight-line basis from 25% to 125%, outperformance by 9% to 18% will result in vesting on a straight-line basis from 125% to 200%. Vesting at 200% will occur if the company outperforms the median TSR performance of the comparator group by at least 18%. For awards made in 2006, the companies in the comparator group are ABN Amro Holdings N.V.; Banco Santander Central Hispano, S.A.; Barclays PLC; Citigroup Inc; HBOS plc; HSBC Holdings plc; Lloyds TSB Group plc and Standard Chartered PLC. The Remuneration Committee considers this group to be appropriate in the context of the Group's business.

Directors' remuneration report continued

The EPS element ensures a clear line of sight for executives to improve long-term financial performance. For this element, the level of EPS growth over the three year period will be calculated by comparing the adjusted EPS in the year prior to the year of grant with that in the final year of the performance period. Each year the vesting schedule for the EPS growth measure will be agreed by the Remuneration Committee at the time of grant, having regard to the business plan, performance relative to comparators and analysts' forecasts.

For the awards made in 2006, the awards will not vest if EPS growth is below 5% per annum over the three year period. Where EPS growth is between 5% per annum and 10% per annum vesting will occur on a straight-line basis from 25% to 100%. Vesting at 100% will occur if EPS growth is at least 10% per annum.

Options

In 2006, awards were made under the executive share option scheme approved by shareholders in January 1999. Options granted to executive directors were over shares worth between one and a quarter times salary and two and a half times salary, based on the market value at the date of grant. These options are exercisable only if, over a three year period from the date of grant, the growth in the company's EPS has exceeded the growth in the RPI plus 9%.

A new executive share option plan is being submitted for approval at the company's Annual General Meeting in 2007. It is proposed that, subject to approval at the Annual General Meeting, the first grants under this plan will be made following the Annual General Meeting. Grants to executive directors will be made over shares worth up to 300% of salary with an EPS performance condition. The performance condition will be based on the average annual growth in the Group's adjusted EPS over the three year performance period commencing with the year of grant. The calibration of the EPS growth measure will be agreed by the Remuneration Committee at the time of each grant having regard to the business plan, prevailing economic conditions and analysts' forecasts.

Shareholding guidelines

In 2006, the Remuneration Committee reviewed the policy on shareholding requirements and the Group has now adopted shareholding guidelines for executive directors.

The target shareholding level is 200% of gross annual salary for the Group Chief Executive and 100% of gross annual salary for executive directors. Target shareholding levels are determined by reference to ordinary shares held, together with any vested awards under the Group's Medium-term Performance Plan. Executive directors have a period of five years in which to build up their shareholdings to meet the guideline levels.

Group Finance Director – Guy Whittaker

Guy Whittaker joined the Group on 1 February 2006. On recruitment, Mr Whittaker was compensated for the value of restricted stock and unvested options he forfeited on departure from his previous employer. This compensation took the form of a grant of ordinary shares in The Royal Bank of Scotland Group plc worth £1,000,000 and restricted stock worth £1,450,000, the latter vesting in three tranches between 2007 and 2009. In addition, Mr Whittaker forfeited his performance bonus from his previous employer and was compensated by a cash payment of £1,195,181 and a grant of restricted stock worth £962,785, the latter vesting in four tranches between 2007 and 2010. Mr Whittaker's current remuneration package is in line with those of the Group's other UK-based executive directors.

US based director – Lawrence Fish

The remuneration policy for Mr Fish is as follows:

Base salary is set having regard to the levels of base salary in other US banks and the appropriate balance of fixed and variable remuneration for US based executives of UK listed companies operating within the corporate governance frameworks of the UK.

Benefits Mr Fish accrues pension benefits under a number of arrangements in the US. Details are provided on page 86. In addition he is entitled to receive other benefits on a similar basis to other Citizens employees.

Short-term performance rewards take the form of an annual incentive plan which rewards the achievement of Group, business unit and individual financial and non-financial targets. The normal maximum annual bonus potential is two times salary, although additional amounts to a maximum of a further two times salary may be awarded, at the discretion of the Board, for exceptional performance as measured by the achievement of significant objectives.

Long-term incentives consist of the following components:

- The last grant made under the Citizens Phantom 2000 Plan vested on 1 January 2006. The value of units at the time of vesting was based on the cumulative economic profit generated by Citizens, the trend in economic profit and on the external market trends in the US banking sector, using price/earnings ratios of comparator US banks.

- A grant under the Group's Medium-term Performance Plan within the levels, and on the same terms, available to UK based executives.

- A grant under the executive share option scheme within the levels, and on the same terms, available to UK based executives. In 2007, Mr Fish will be eligible for a grant under the new executive share option plan if approved by shareholders at the company's Annual General Meeting.

- A grant under the new Citizens Long Term Incentive Plan approved by shareholders at the company's Annual General Meeting in 2005. Performance is measured on a combination of Growth in Profit before Tax and Relative Return on Equity based on a comparison of Citizens with comparator US banks. The targets for this plan are set on an annual basis over the three year term of the grant. The target value of the award made under the plan in 2005 was 33% of salary and in 2006 was 75% of salary. Each award may deliver up to a maximum of twice the target value.

Total shareholder return performance

The undernoted performance graph illustrates the performance of the company over the past five years in terms of total shareholder return compared with that of the companies comprising the FTSE 100 Index. This Index has been selected because it represents a cross-section of leading UK companies. The total shareholder return for the company and the FTSE 100 have been rebased to 100 for 2001.

Total shareholder return

Service contracts

The company's policy in relation to the duration of contracts with directors is that executive directors' contracts generally continue until termination by either party, subject to the required notice, or until retirement. The notice period under the service contracts of executive directors will not normally exceed 12 months. In relation to newly recruited executive directors, subject to the prior approval of the Remuneration Committee, the notice period from the employing company required to terminate the contract will not normally exceed 12 months unless there is a clear case for this. Where a longer period of notice is initially approved on appointment, it will normally be structured such that it will automatically reduce to 12 months in due course.

All new service contracts for executive directors are subject to approval by the Remuneration Committee. Those contracts normally include standard clauses covering the performance review process, the company's normal disciplinary procedure, and terms for dismissal in the event of failure to perform or in situations involving actions in breach of the Group's policies.

Any compensation payment made in connection with the departure of an executive director will be subject to approval by the Remuneration Committee, having regard to the terms of the service contract and the reasons for termination.

Information regarding executive directors' service contracts is summarised in the table and notes below.

Name	Date of current contract/ Employing company	Notice period – from company	Notice period – from executive
Sir Fred Goodwin	1 August 1998 The Royal Bank of Scotland plc	12 months	6 months
Mr Cameron	29 March 1998 The Royal Bank of Scotland plc	12 months	6 months
Mr Fish	18 February 2004 Citizens Financial Group, Inc.	12 months	12 months
Mr Fisher	27 February 2007 The Royal Bank of Scotland plc	12 months	12 months
Mr Pell	20 February 2006 The Royal Bank of Scotland plc	12 months	6 months

Mr Whittaker	19 December 2005 The Royal Bank of Scotland plc	12 months	12 months

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Directors' remuneration report continued

Except as noted below, in the event of severance of contract where any contractual notice period is not worked, the employing company may pay a sum to the executive in lieu of this period of notice. Any such payment would, at maximum, comprise base salary and a cash value in respect of fixed benefits (including pension plan contributions). In the event of situations involving breach of the employing company's policies resulting in dismissal, reduced or no payments may be made to the executive. Depending on the circumstances of the termination of employment, the executive may be entitled, or the Remuneration Committee may exercise its discretion to allow, the executive to exercise outstanding awards under long-term incentive arrangements subject to the rules of the relevant plan. All UK based directors, with the exception of Guy Whittaker, are members of The Royal Bank of Scotland Group Pension Fund ("the RBS Fund") and are contractually entitled to receive all pension benefits in accordance with its terms. The RBS Fund rules allow all members who retire early at the request of their employer to receive a pension based on accrued service with no discount applied for early retirement.

The Remuneration Committee has reviewed this provision of the RBS Fund, which applies equally to executive directors and other employees. The Remuneration Committee concluded that a change to the terms of the RBS Fund in respect of early retirement at the company's request would not be a cost effective route to take at this time. The RBS Fund is closed to employees, including any executive directors, joining the Group after 30 September 2006.

The exception to these severance arrangements relates only to Mr Fish. If Mr Fish's contract is terminated without cause, or if he terminates the contract for good reason (as defined in the contract), he is entitled to a lump sum payment to compensate him for the loss of 12 months salary plus annual bonus. Mr Fish would also be entitled to receive for this period health, life insurance and long term disability coverage and any other benefits determined in accordance with the plans, policies and practices of Citizens at the time of termination. The Remuneration Committee has been advised that these termination provisions are less generous than the current market practice in the US.

Chairman and non-executive directors

The original date of appointment as a director of the company and the latest date for the next re-election are as follows:

	Date first appointed	Latest date for next re-election
Sir Tom McKillop	1 September 2005	2009
Mr Buchan	1 June 2002	2009
Dr Currie	28 November 2001	2008
Mr Friedrich	1 March 2006	2009
Mr Hunter	1 September 2004	2008
Mr Koch	29 September 2004	2008
Mrs Kong	1 January 2006	2009
Mr MacHale	1 September 2004	2008
Sir Steve Robson	25 July 2001	2008
Mr Scott	31 January 2001	2009
Mr Sutherland	31 January 2001	2009

The non-executive directors do not have service contracts or notice periods although they have letters of engagement reflecting their responsibilities and commitments. Under the company's articles of association, all directors must retire by rotation and seek re-election by shareholders at least every three years. The dates in the table above reflect the latest date for re-election. However, in 2007, at least one-third of the Board will retire by rotation as required by the company's articles of association. No compensation would be paid to the Chairman or to any non-executive director in the event of early termination.

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The tables and explanatory notes on pages 81 to 86 report the remuneration of each director for the year ended 31 December 2006 and have been audited by the company’s auditors, Deloitte & Touche LLP.

Directors’ remuneration

	Salary/ fees £000	Performance bonus(1) £000	Pension allowance £000	Benefits £000	Other £000	2006 Total £000	200 Tota £00
Chairman							
Sir Tom McKillop (appointed Chairman on 28 April 2006)	471	—	—	—	—	471	67
Sir George Mathewson (retired 28 April 2006) (2)	199	—	—	1	—	200	607
Executive directors							
Sir Fred Goodwin	1,190	2,760	—	46	—	3,996	2,893
Mr Cameron (appointed 1 March 2006) (3)	889	2,340	236	31	—	3,496	—
Mr Fish (4)	1,017	1,627	—	35	—	2,679	2,509
Mr Fisher (appointed 1 March 2006) (3)	654	1,105	122	13	—	1,894	—
Mr Pell	790	1,309	—	21	—	2,120	1,580
Mr Watt (resigned 31 January 2006) (5)	57	55	—	5	—	117	1,399
Mr Whittaker (appointed 1 February 2006) (6)	663	1,190	228	2	2,392	4,475	—

Notes:

(1) Includes 10% profit sharing. The performance bonus for Mr Cameron and Mr Fisher reflects their performance for the full year.

(2) From 28 April 2006, Sir George has been employed as an adviser to the Group. Under this employment agreement dated 26 April 2006, which runs until 31 July 2009, Sir George received a fee of £179,000 for his services under this agreement in 2006, comprising £150,000 in respect of certain duties performed in the connection with the handover of his responsibilities to Sir Tom McKillop in the three month period following the Annual General Meeting and thereafter at the rate of £75,000 per annum. Under this arrangement he also received medical insurance, life assurance cover and secretarial and administrative support necessary for the performance of his duties.

(3) The above figures include remuneration paid to Mr Cameron and Mr Fisher prior to their appointment as directors. For this period, Mr Cameron and Mr Fisher received salary and benefits of £141,000 and £105,000 respectively.

(4) Mr Fish is a non-executive director of Textron Inc. and retains the fees paid to him in this respect. For 2006, he received a remuneration package from Textron Inc. equivalent to approximately US$84,974.

(5) Following his resignation as a director on 31 January 2006, Mr Watt remained employed by the Group until 28 February 2006 in order to facilitate a handover of duties to his successor. For this period, Mr Watt received remuneration of £112,000, comprising £57,000 in respect of salary and benefits, and £55,000 in respect of performance bonus.

(6) Included in other remuneration for Mr Whittaker is an award of ordinary shares in the company of £1,000,000, a cash payment of £1,195,181 and relocation expenses of £197,211.

Non-executive directors	Board fees £000	Board committee fees £000	2006 Total £000	2005 Total £000
Mr Buchan	65	55	120	109
Dr Currie	65	15	80	68
Mr Friedrich (appointed 1 March 2006)	54	15	69	—
Mr Hunter	65	93	158	113
Mr Koch (1)	65	—	65	55

Mrs Kong (appointed 1 January 2006)	65	8	73	
Mr MacHale	65	30	95	80
Sir Steve Robson	65	30	95	80
Mr Scott (2)			155	100
Mr Sutherland	65	23	88	60

Notes:

(1) In addition to his role as a non-executive director, Mr Koch has an agreement with Citizens Financial Group, Inc. to provide consulting services for a period of three years following the acquisition by Citizens of Charter One Financial, Inc. For these services Mr Koch receives $402,500 per annum.

(2) Mr Scotts senior independent director fee covers all Board and Board Committee work including Chairmanship of the Remuneration Committee.

No director received any expense allowances chargeable to UK income tax or compensation for loss of office/termination payment. The non-executive directors did not receive any bonus payments or benefits.

Directors' remuneration report continued

Share options

Options to subscribe for ordinary shares of 25p each in the company granted to, and exercised by, directors during the year to 31 December 2006 are included in the table below:

			Options exercised in 2006			Options held at 31 December 2006	
	Options held at 1 January 2006	Options granted in 2006	Number	Market price at date of exercise £	Option price £	Number	Exercise period
Sir George Mathewson (2)	69,257				9.33	69,257	11.05.01 – 10.05.08
	147,247				7.81	147,247	29.03.03 – 28.03.10
	150				12.40	150	09.08.03 – 08.08.06(1)
	20,100				17.18	20,100	14.08.04 – 13.08.11
	19,500				18.18	19,500	14.03.05 – 13.03.12
	36,400				12.37	36,400	13.03.06 – 12.03.13
	36,044				17.34	36,044	11.03.07 – 10.03.14
	41,570				17.29	41,570	10.03.08 – 09.03.15
	1,347				13.64	1,347	01.10.08 – 31.03.09(1)
	371,615					371,615	
Sir Fred Goodwin	164,571				8.75	164,571	07.12.01 – 06.12.08
	2,963				11.18	2,963	04.03.02 – 03.03.09
	27,306				11.97	27,306	03.06.02 – 02.06.09
	153,648				7.81	153,648	29.03.03 – 28.03.10
	43,700				17.18	43,700	14.08.04 – 13.08.11
	41,300				18.18	41,300	14.03.05 – 13.03.12
	72,800				12.37	72,800	13.03.06 – 12.03.13
	144,175				17.34	144,175	11.03.07 – 10.03.14
	159,051				17.29	159,051	10.03.08 – 09.03.15
	1,267				13.04	1,267	01.10.10 – 31.03.11(1)
		161,987			18.52	161,987	09.03.09 – 08.03.16
	810,781	161,987				972,768	
Mr Cameron (3)	19,194				11.18	19,194	04.03.02 – 03.03.09
	38,411				7.81	38,411	29.03.03 – 28.03.10
	150				15.63	150	04.04.04 – 03.04.07(1)
	26,200				17.18	26,200	14.08.04 – 13.08.11
	31,800				18.18	31,800	14.03.05 – 13.03.12
	52,600				12.37	52,600	13.03.06 – 12.03.13

	50,461				17.34	50,461	11.03.07 – 10.03.14
	1,865				9.85	1,865	01.10.07 – 31.03.08(1)
	80,972				17.29	80,972	10.03.08 – 09.03.15
		85,043			18.52	85,043	09.03.09 – 08.03.16
	301,653	85,043				386,696	
Mr Fish	107,877				9.33	107,877	11.05.01 – 10.05.08
	150		150	17.36	12.40	–	
	37,603				17.29	37,603	10.03.08 – 09.03.15
		111,129			18.52	111,129	09.03.09 – 08.03.16
	145,630	111,129	150			256,609	
Mr Fisher (3)	14,281				9.24	14,281	01.04.02 – 31.03.09
	33,291				7.81	33,291	29.03.03 – 28.03.10
	21,800				17.18	21,800	14.08.04 – 13.08.11
	22,700				18.18	22,700	14.03.05 – 13.03.12
	40,500				12.37	40,500	13.03.06 – 12.03.13
	283		283	18.27	13.07	–	
	39,648				17.34	39,648	11.03.07 – 10.03.14
	311				12.09	311	01.10.07 – 31.03.08(1)
	60,729				17.29	60,729	10.03.08 – 09.03.15
	145				13.04	145	01.10.08 – 31.03.09(1)
		61,420			18.52	61,420	09.03.09 – 08.03.16
	233,688	61,420	283			294,825	

	Options held at 1 January 2006	Options granted in 2006	Options exercised in 2006		Option price £	Options held at 31 December 2006	
			Number	Market price at date of exercise £		Number	Exercise period
Mr Pell	51,216				7.81	51,216	29.03.03 28.03.10
	29,100				17.18	29,100	14.08.04 13.08.11
	27,600				18.18	27,600	14.03.05 13.03.12
	49,800				12.37	49,800	13.03.06 12.03.13
	47,217				17.34	47,217	11.03.07 10.03.14
	50,607				17.29	50,607	10.03.08 09.03.15
		62,365			18.52	62,365	09.03.09 08.03.16
	255,540	62,365				317,905	
Mr Watt (4)	70,148				12.83	70,148	04.09.03 03.09.10
	23,300				17.18	23,300	14.08.04 13.08.11
	22,100				18.18	22,100	14.03.05 13.03.12
	42,500				12.37	42,500	13.03.06 12.03.13
	43,253				17.34	43,253	11.03.07 10.03.14
	57,259				17.29	57,259	10.03.08 09.03.15
	258,560					258,560	
Mr Whittaker (5)		56,695			18.52	56,695	09.03.09 08.03.16
		1,235			13.84	1,235	01.10.13 31.03.14(1)
		57,930				57,930	

Notes:

(1) Options held under the sharesave and option 2000 schemes, which are not subject to performance conditions.

(2) Sir George Mathewson retired from the Board on 28 April 2006. The figures quoted above are as at cessation. Subsequently, Sir George exercised his option over 150 shares on 8 June 2006.

(3) Options held at 1 January 2006 by Mr Cameron and Mr Fisher were granted prior to their appointment to the Board on 1 March 2006.

(4) Mr Watt resigned from the Board on 31 January 2006. The figures quoted above are as at cessation. Subsequently, Mr Watt exercised all of his options on 10 October 2006.

(5) Mr Whittaker was appointed to the Board on 1 February 2006.

The performance conditions for options granted in 2006 are detailed on page 78.

No options had their terms and conditions varied during the accounting period to 31 December 2006. No payment is required on the award of an option.

The executive share options which are exercisable from March 2002 onwards are subject to the satisfaction of an EPS growth target which provides that options are exercisable only if, over a three year period, the growth in the companys EPS has exceeded the growth in the RPI plus 9%. In respect of executive share options exercisable before March 2002 the performance condition is that the growth in the company's EPS over three years has exceeded the growth in the RPI plus 6%.

The market price of the company's ordinary shares at 31 December 2006 was £19.93 and the range during the year to 31 December 2006 was £16.69 to £19.99.

In the ten year period to 31 December 2006, awards made that could require new issue shares under the company's share plans represented 4.8% of the company's issued ordinary share capital, leaving an available dilution headroom of 5.2%.

Directors remuneration report continued

Medium Term Performance Plan

	Scheme interests (share equivalents) at 1 January 2006	Awards granted in 2006	Market price on award £	Awards vested in 2006(1)	Awards exercised in 2006	Market price on exercise £	Share interest (share equivalents) at 31 December 2006	End of period for qualifying conditions to be fulfilled
Sir Fred Goodwin	93,040		16.35				93,040	vested 31.12.03
	33,855		18.59				33,855	vested 31.12.04
	86,506		17.34	Nil				lapsed 31.12.06
	95,431		17.29				95,431	31.12.07
		97,193	18.52				97,193	31.12.08
	308,832						319,519	
Mr Cameron (2)	55,824		16.35				55,824	vested 31.12.03
	22,078		18.59				22,078	vested 31.12.04
	40,370		17.34	Nil				lapsed 31.12.06
	46,270		17.29				46,270	31.12.07
		48,597	18.52				48,597	31.12.08
	164,542						172,769	
Mr Fish	35,274		17.34	Nil				lapsed 31.12.06
	10,495		17.29				10,495	31.12.07
		31,117	18.52				31,117	31.12.08
	45,769						41,612	
Mr Fisher (2)	20,000		16.35				20,000	vested 31.12.03
	8,000		18.59				8,000	vested 31.12.04
	31,719		17.34	Nil				lapsed 31.12.06
	34,703		17.29				34,703	31.12.07
		35,098	18.52				35,098	31.12.08
	94,422						97,801	
Mr Pell	22,026		16.35		22,026	19.09		vested 31.12.03
	37,774		17.34	Nil				lapsed 31.12.06
	40,486		17.29				40,486	31.12.07
		41,577	18.52				41,577	31.12.08
	100,286						82,063	

Mr Watt (3)	18,877		18.59	18,877	vested 31.12.04
	34,603		17.34	–	–
	38,173		17.29	–	–
	91,653			18,877	
Mr Whittaker (4)	–	37,797	18.52	37,797	31.12.08

Notes:

(1) Awards were granted on 9 April 2004 and these awards have now lapsed.

(2) Scheme interests at 1 January 2006 of Mr Cameron and Mr Fisher were awarded prior to their appointment to the Board on 1 March 2006.

(3) Mr Watt resigned from the Board on 31 January 2006. Mr Watt subsequently exercised his 2002 award (which vested on 31 December 2004) on 7 March 2006. All remaining awards lapsed at cessation of employment.

(4) Mr Whittaker was appointed to the Board on 1 February 2006.

For any awards that have vested, participants holding option-based awards can exercise their right over the underlying share equivalents at any time up to ten years from the date of grant.

No variation was made to any of the terms of the plan during the year. The performance measures are detailed on pages 77 and 78.

Directors' remuneration report continued

Restricted Stock Award

	Awards granted in 2006 and held at 31 December 2006	Market price on award £	End of the period for qualifying conditions to be fulfilled(3)
Mr Whittaker (1)	56,285	19.38	01.02.07(2)
	30,483	19.38	01.02.08
	25,322	19.38	01.02.09
	12,421	19.38	01.02.10
	124,511		

Notes:

(1) Awards were granted to Mr Whittaker in lieu of unvested share awards from his previous employer. Further information on these awards is set out on page 78.

(2) Award has now vested and shares will be released to Mr Whittaker on 1 March 2007.

(3) The end period for qualifying conditions is subject to any restrictions on dealing in the Group's shares which may be in place and to which Mr Whittaker may be subject. As a result of the close period prior to the announcement of the Group's results on 1 March 2007, the end of the period for qualifying conditions to be fulfilled in 2007 is 1 March 2007.

Phantom 2000 Plan

		Awards granted during year				
	Phantom 2000 units at 1 January 2006	Units awarded during year	Market price on award	End of the period for qualifying conditions to be fulfilled	Benefits received during year	Phantom 2000 units at 31 December 2006
Mr Fish	1,000,000			01.01.05	US$6,100,000	–

No variation was made to any of the terms of the plan during the year. The performance measures are detailed on page 78.

Citizens Long Term Incentive Plan(1)

	Interests at 1 January 2006	Awards granted during year	Benefits received during year	Interests at 31 December 2006
Mr Fish	LTIP awards for the 3 year periods: 01.01.03 – 31.12.05 01.01.04 – 31.12.06	LTIP award for the 3 year period:	LTIP award for the 3 year period: 01.01.03 – 31.12.05 was US$1,268,747	LTIP awards for the 3 year periods: 01.01.04 – 31.12.06

01.01.05 – 31.12.07		01.01.05 – 31.12.07
	01.01.06 – 31.12.08	01.01.06 – 31.12.08

Note:

(1) A new cash LTIP was approved by shareholders at the company’s Annual General Meeting in April 2005. Details are given on page 78. This replaced the previous LTIP which provided for a target payment of 60% of average salary over the three year period and a maximum payment of 105% of average salary.

No variation was made to any of the terms of the plan during the year. The performance measures are detailed on page 78.

Directors’ remuneration report continued

Directors’ pension arrangements

During the year, Johnny Cameron, Mark Fisher, Sir Fred Goodwin, Gordon Pell and Fred Watt participated in The Royal Bank of Scotland Group Pension Fund (‘the RBS Fund’). The RBS Fund is a defined benefit fund registered with HM Revenue & Customs under the Finance Act 2004.

The legislation governing the taxation of pensions in the UK changed with effect from April 2006. No changes have been made to the level of pension benefits of any of the directors as a result of this legislation, however the arrangements for providing some benefits have changed as follows.

Arrangements had previously been made to provide Sir Fred Goodwin and Gordon Pell with additional pension benefits on a defined benefit basis outwith the RBS Fund. No changes have been made to the overall level of benefits to be provided, but the amount which can be provided from within the RBS Fund may be different than previously envisaged. The figures shown below include the accrual in respect of these arrangements.

Johnny Cameron and Fred Watt were provided with additional pension benefits on a defined contribution basis and the contributions made in the year are shown below. These contributions ceased with effect from April 2006 and were replaced by a salary supplement which is shown in the table on page 81.

Mark Fisher opted to cease future accrual of pension benefit within the RBS Fund with effect from 6 April 2006 and to receive instead a salary supplement. Guy Whittaker has been provided with a salary supplement in place of pension benefits since his employment started. These cash allowances are shown in the table on page 81.

Of the total transfer value shown as at 31 December 2006, 34% relates to benefits in funded pension schemes.

Sir George Mathewson received life assurance cover under an individual arrangement until his retirement from the Board. Details of his current benefits are set out on page 81.The non-executive directors do not accrue pension benefits or receive life assurance cover.

Lawrence Fish accrues pension benefits under a number of arrangements in the US. Defined benefits are built up under the Citizens’ Qualified Plan, Excess Plan and Supplemental Executive Retirement Arrangement. In addition, he is a member of two defined contribution arrangements: a Qualified 401(k) Plan and an Excess 401(k) Plan.

Disclosure of these benefits has been made in accordance with the United Kingdom Listing Authority Listing Rules and with the Directors’ Remuneration Report Regulations 2002.

Defined benefit arrangements	Age at 31 December 2006	Accrued entitlement at 31 December 2006 £000 p.a.	Additional pension earned during the year ended 31 December 2006 £000 p.a.	Additional pension earned during the year ended 31 December 2006* £000 p.a.	Transfer value as at 31 December 2006 £000	Transfer value as at 31 December 2005 £000	Increase in transfer value during year ended 31 December 2006 £000	fo
Sir Fred Goodwin	48	510	66	54	7,043	5,119	1,924	
Mr Cameron	52	51	4	3	824	655	169	
Mr Fish	62	$1,829	$445	$445	$17,800	$13,347	$4,453	
Mr Fisher	46	302	26	18	3,904	2,978	926	
Mr Pell	56	361	59	51	6,744	5,092	1,652	
Mr Watt	45	10	1	—	108	96	12	

* net of statutory revaluation applying to deferred pensions

Notes:

(1) There is a significant difference in the form of disclosure required by the Combined Code and the Directors’ Remuneration Report Regulations 2002. The former requires the disclosure of the additional pension earned during the year and the transfer value equivalent to this pension based on stock market conditions at the end of the year. The latter requires the disclosure of the difference between the transfer value at the start and end of the year and is therefore dependent on the change in stock market conditions over the course of the year. The above disclosure has been made in accordance with the Combined Code and the Directors’ Remuneration Report Regulations 2002.

(2) The transfer values disclosed above do not represent a sum paid or payable to the individual director. Instead they represent a potential liability of the Group pension scheme.

(3) No allowance is made in these transfer values for any enhanced benefits that may become payable on early retirement.

(4) The proportion of benefits represented by funded pension schemes for Sir Fred Goodwin, Gordon Pell and Lawrence Fish is 3%, 60% and 2% respectively. All benefits for Johnny Cameron, Mark Fisher and Fred Watt are in funded pension schemes.

(5) In accordance with US market practice, Mr Fish’s pensionable remuneration is limited to US$4 million per annum.

(6) The above figures include pension accrued for Mr Watt for the period until cessation of employment on 28 February 2006.

Contributions and allowances paid in the year ended 31 December 2006 under defined contribution arrangements were:

	2006 000	2005 000
Mr Cameron	£46	–
Mr Watt	£25	£144
Mr Fish	$56	$139

Bob Scott
Chairman of the Remuneration Committee
28 February 2007

Directors' interests in shares

Executive directors	Shares beneficially owned at 1 January 2006 or date of appointment if later	31 December 2006 Shares owned beneficially	Vested MPP shares or share equivalents	Vested share options	Total	Value a 31 Decen 2
Sir Fred Goodwin	66,762	66,844	126,895	506,288	700,027	£8,549,4
Mr Cameron (appointed 1 March 2006)	1,827	2,012	77,902	168,355	248,269	£2,752,1
Mr Fish	11,120	11,120	—	107,877	118,997	£1,365,1
Mr Fisher (appointed 1 March 2006)	3,917	4,498	28,000	132,572	165,070	£1,609,6
Mr Pell	582	582	—	157,716	158,298	£1,137,1
Mr Whittaker (appointed 1 February 2006)	—	51,605	—	—	51,605	£1,028,4

Notes:

(1) The numbers shown in this table are taken from the audited disclosures shown elsewhere in this Annual Report.

(2) The value is based on the share price at 29 December 2006, which was £19.93. During the year ended 31 December 2006 the share price ranged from £16.69 to £19.99.

(3) The notional value of the vested share options has been calculated on the "in the money" value.

(4) As at 31 December 2006, the executive directors held a technical interest as potential beneficiaries in The Royal Bank of Scotland Group plc 2001 Employee Share Trust (5,987,597 shares) and The Royal Bank of Scotland plc 1992 Employee Share Trust (509,905 shares), being trusts operated for the benefit of employees of the company and its subsidiaries.

Non-executive directors	Shares beneficially owned at 1 January 2006 or date of appointment if later	Shares beneficially owned at 31 December 2006
Chairman		
Sir Tom McKillop	30,000	30,000
Mr Buchan	5,000	5,000
Dr Currie	556	556
Mr Friedrich (appointed 1 March 2006)	—	20,256
Mr Hunter	3,500	3,500
Mrs Kong	1,120	7,000
Mr Koch	20,000	20,000
Mr MacHale	10,000	10,000
Mr Scott	4,448	4,448
Mr Sutherland	5,590	5,590

No other director had an interest in the company’s ordinary shares during the year.

On both 8 January 2007 and 7 February 2007, six ordinary shares of 25p each were acquired by Sir Fred Goodwin and Mr Fisher under the Group’s Buy As You Earn share scheme.

On 18 January 2007, Mr Cameron acquired 1,466 ordinary shares of 25p each from the late Sir Donald and Lady Cameron Marriage Settlement Trust.

Preference shares

Mr Fish held 20,000 non-cumulative preference shares of US$0.01 each at 31 December 2006 (2005 – 20,000) and Mr Koch held 20,000 non-cumulative preference shares of US$0.01 each at 31 December 2006 (2005 – 20,000). No other director had an interest in the preference shares during the year.

The company’s Register of Directors’ Interests, which is open to inspection, contains full details of directors’ shareholdings and options to subscribe.

No director held a non-beneficial interest in the shares of the company at 31 December 2006, at 1 January 2006 or date of appointment if later.

Statement of directors responsibilities

The directors are required by Article 4 of the IAS Regulation (European Commission Regulation No 1606/2002) to prepare Group accounts, and as permitted by the Companies Act 1985 have elected to prepare company accounts, for each financial year in accordance with International Financial Reporting Standards as adopted by the European Union. They are responsible for preparing accounts that present fairly the financial position, financial performance and cash flows of the Group and the company. In preparing those accounts, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent; and
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the accounts.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and to enable them to ensure that the Annual Report and Accounts complies with the Companies Act 1985. They are also responsible for safeguarding the assets of the company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

By order of the Board.

Miller McLean
Secretary
28 February 2007

Financial statements

Report of Independent Registered Public Accounting Firm to the members of The Royal Bank of Scotland Group plc

We have audited the financial statements of The Royal Bank of Scotland Group plc ("the company") and its subsidiaries (together "the Group") for the year ended 31 December 2006 which comprise the accounting policies, the balance sheets as at 31 December 2006 and 2005, the consolidated income statements, the cash flow statements, the statements of recognised income and expense for each of the three years in the period ended 31 December 2006 and the related Notes 1 to 49. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the part of the directors' remuneration report that is described as having been audited.

Respective responsibilities of directors and auditors

As described in the statement of directors' responsibilities, the company's directors are responsible for the preparation of the financial statements in accordance with applicable law and International Financial Reporting Standards ("IFRS") as adopted by the European Union. They are also responsible for the preparation of the other information contained in the 2006 Annual Report including the directors' remuneration report.

Our responsibility is to audit the financial statements and the part of the directors' remuneration report described as having been audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the directors' remuneration report described as having been audited have been properly prepared in accordance with the Companies Act 1985, and as regards the financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion, the information given in the directors' report is consistent with the financial statements. The information given in the director's report includes that specific information presented in the Operating and Financial Review that is cross referred from the business review section of the directors' report.

In addition we report to you if, in our opinion, the company has not kept proper accounting records, we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We review whether the corporate governance statement reflects the company's compliance with the nine provisions of the 2003 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not.

The Listing Rules do not require us to consider whether the Board or management's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the 2006 Annual Report as described in the contents section including the unaudited part of the directors' remuneration report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any further information outside the 2006 Annual Report.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board and with the standards of the Public Company Accounting Oversight Board (United States). An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the directors' remuneration report described as having been audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the circumstances of the company and the Group, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the directors remuneration report described as having been audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the directors remuneration report described as having been audited.

UK opinion

In our opinion:

- the Group financial statements give a true and fair view, in ccordance with IFRS as adopted by the European Union, of the state of the Groups affairs as at 31 December 2006 and of its profit and cash flows for the year then ended;

- the company financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union as applied in accordance with the requirements of the Companies Act 1985, of the state of affairs of the company as at 31 December 2006;

- the financial statements and the part of the directors remuneration report described as having been audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the financial statements, Article 4 of the IAS Regulation; and

- the information given in the directors report is consistent with the financial statements.

Separate opinion in relation to IFRS

As explained in the accounting policies, the Group, in addition to complying with its legal obligation to comply with IFRS as adopted by the European Union, has also complied with the IFRS as issued by the International Accounting Standards Board.

In our opinion the financial statements give a true and fair view, in accordance with IFRS, of the state of the Group's affairs as at 31 December 2006 and of its profit and cash flows for the year then ended.

US opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Group as at 31 December 2006 and 2005 and the results of its operations and its cash flows for each of the three years in the period ended 31 December 2006, in accordance with IFRS.

IFRS vary in certain significant respects from accounting principles generally accepted in the United States of America. Information relating to the nature and the effect of such differences is presented in Note 47 to the financial statements.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Group's internal control over financial reporting as at 31 December 2006, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Our report dated 28 February 2007 which is included in this Annual Report on Form 20-F for the year ended 31 December 2006 expresses an unqualified opinion on management's assessment of the effectiveness of the Group's internal control over financial reporting and an unqualified opinion on the effectiveness of the Group's internal control over financial reporting.

Deloitte & Touche LLP
Chartered Accountants and Registered Auditors
Edinburgh, United Kingdom
28 February 2007

Accounting policies

1. Presentation of accounts

The accounts are prepared in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board (‘IASB’) and interpretations issued by the International Financial Reporting Interpretations Committee of the IASB (together ‘IFRS’) as adopted by the European Union (‘EU’). The EU has not adopted the complete text of IAS 39 ‘Financial Instruments: Recognition and Measurement’; it has relaxed some of the standard’s hedging requirements. The Group has not taken advantage of this relaxation and has adopted IAS 39 as issued by the IASB. The date of transition to IFRS for the Group and the company (The Royal Bank of Scotland Group plc) and the date of their opening IFRS balance sheets was 1 January 2004.

The company is incorporated in the UK and registered in Scotland. The accounts are prepared on the historical cost basis except that the following assets and liabilities are stated at their fair value: derivative financial instruments, held-for-trading financial assets and financial liabilities, financial assets and financial liabilities that are designated as at fair value through profit or loss, available-for-sale financial assets and investment property. Recognised financial assets and financial liabilities in fair value hedges are adjusted for changes in fair value in respect of the risk that is hedged.

The company accounts are presented in accordance with the Companies Act 1985.

Change of accounting policy

As permitted by IFRS 1, the Group and the company implemented IAS 32 ‘Financial Instruments: Disclosure and Presentation’, IAS 39 ‘Financial Instruments: Recognition and Measurement’ and IFRS 4 ‘Insurance Contracts’ with effect from 1 January 2005 without restating the income statement, balance sheet and notes for 2004. The Group adopted the second amendment to IAS 39 ‘The Fair Value Option’ issued by the IASB in June 2005 also from 1 January 2005. The effect of implementing IAS 32, IAS 39 and IFRS 4 on the Group and company balance sheets and shareholders’ funds as at 1 January 2005 is set out in Note 46. In preparing the 2004 comparatives, UK GAAP principles then current have been applied to financial instruments. The main differences between UK GAAP and IFRS on financial instruments are summarised in Note 46 on the accounts.

The IASB’s amendment to IAS 39, ‘Cash Flow Hedge Accounting of Forecast Intragroup Transactions’, published in April 2005, amended IAS 39 to permit the foreign currency risk of a highly probable forecast intragroup transaction to qualify as a hedged item in consolidated financial statements. The amendment, effective for annual periods beginning on or after 1 January 2006, had no material effect on the financial statements of the Group or the company.

The IASB’s amendment to IAS 39, ‘Financial Guarantee Contracts’, published in August 2005, amended IAS 39 and IFRS 4. The amendment defines a financial guarantee contract and requires such contracts to be recorded initially at fair value and subsequently at higher of the provision determined in accordance with IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’ and the amount initially recognised less amortisation. The amendment, effective for annual periods beginning on or after 1 January 2006, had no material effect on the Group or the company.

In December 2005, the IASB issued an amendment to IAS 21 ‘The Effects of Changes in Foreign Exchange Rates’ to clarify that a monetary item can form part of the net investment in overseas operations regardless of the currency in which it is denominated and that the net investment in a foreign operation can include a loan from a fellow subsidiary. The amendment, adopted by the EU in May 2006, had no material effect on the Group or the company.

2. Basis of consolidation

The consolidated financial statements incorporate the financial statements of the company and entities (including certain special purpose entities) controlled by the Group (its subsidiaries). Control exists where the Group has the power to govern the financial and operating policies of the entity; generally conferred by holding a majority of voting rights. On acquisition of a subsidiary, its identifiable assets, liabilities and contingent liabilities are included in the consolidated accounts at their fair value. Any excess of the cost (the fair value of assets given, liabilities incurred or assumed and equity instruments issued by the Group plus any directly attributable costs) of an acquisition over the fair value of the net assets acquired is recognised as goodwill. The interest of minority shareholders is stated at their share of the fair value of the subsidiary's net assets.

The results of subsidiaries acquired are included in the consolidated income statement from the date control passes to the Group. The results of subsidiaries sold are included up until the Group ceases to control them.

All intra-group balances, transactions, income and expenses are eliminated on consolidation. The consolidated accounts are prepared using uniform accounting policies.

3. Revenue recognition

Interest income on financial assets that are classified as loans and receivables, available-for-sale or held-to-maturity and interest expense on financial liabilities other than those at fair value through profit or loss are determined using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or financial liability (or group of financial assets or liabilities) and of allocating the interest income or interest expense over the expected life of the asset or liability. The effective interest rate is the rate that exactly discounts estimated future cash flows to the instrument's initial carrying amount. Calculation of the effective interest rate takes into account fees receivable, that are an integral part of the instrument's yield, premiums or discounts on acquisition or issue, early redemption fees and transaction costs. All contractual terms of a financial instrument are considered when estimating future cash flows.

Financial assets and financial liabilities held-for-trading or designated as at fair value through profit or loss are recorded at fair value. Changes in fair value are recognised in profit or loss together with dividends and interest receivable and payable.

Commitment and utilisation fees are determined as a percentage of the outstanding facility. If it is unlikely that a specific lending arrangement will be entered into, such fees are taken to profit or loss over the life of the facility otherwise they are deferred and included in the effective interest rate on the advance.

Fees in respect of services are recognised as the right to consideration accrues through the provision of the service to the customer. The arrangements are generally contractual and the cost of providing the service is incurred as the service is rendered. The price is usually fixed and always determinable. The application of this policy to significant fee types is outlined below.

Payment services: this comprises income received for payment services including cheques cashed, direct debits, Clearing House Automated Payments (the UK electronic settlement system) and BACS payments (the automated clearing house that processes direct debits and direct credits). These are generally charged on a per transaction basis. The income is earned when the payment or transaction occurs. Charges for payment services are usually debited to the customer□s account, monthly or quarterly in arrears. Accruals are raised for services provided but not charged at period end.

Card related services: fees from credit card business include:

Commission received from retailers for processing credit and debit card transactions: income is accrued to the income statement as the service is performed.

Interchange received: as issuer, the Group receives a fee (interchange) each time a cardholder purchases goods and services. The Group also receives interchange fees from other card issuers for providing cash advances through its branch and Automated Teller Machine networks. These fees are accrued once the transaction has taken place.

An annual fee payable by a credit card holder is deferred and taken to profit or loss over the period of the service i.e. 12 months.

Insurance brokerage: this is made up of fees and commissions received from the agency sale of insurance. Commission on the sale of an insurance contract is earned at the inception of the policy as the insurance has been arranged and placed. However, provision is made where commission is refundable in the event of policy cancellation in line with estimated cancellations.

Investment management fees: fees charged for managing investments are recognised as revenue as the services are provided. Incremental costs that are directly attributable to securing an investment management contract are deferred and charged as expense as the related revenue is recognised.

Insurance premiums □ see accounting policy 10 below.

4. Pensions and other post-retirement benefits

The Group provides post-retirement benefits in the form of pensions and healthcare plans to eligible employees.

For defined benefit schemes, scheme liabilities are measured on an actuarial basis using the projected unit credit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the scheme liabilities. Scheme assets are measured at their fair value. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit). The current service cost and any past service costs together with the expected return on scheme assets less the unwinding of the discount on the scheme liabilities is charged to operating expenses. Actuarial gains and losses are recognised in full in the period in which they occur outside profit or loss and presented in the statement of recognised income and expense.

Contributions to defined contribution pension schemes are recognised in the income statement when payable.

5. Intangible assets and goodwill