PUBLIC SERVICE ENTERPRISE GROUP INC
Form 424B5
December 16, 2002

PROSPECTUS SUPPLEMENT
(To Prospectus dated December 5, 2002)

7,200,000 Preferred Securities

PSEG Funding Trust II

8.75% Preferred Securities
(Liquidation Amount $25 per Preferred Security)
Fully and Unconditionally Guaranteed to the Extent Set Forth Herein by

Public Service Enterprise Group Incorporated

PSEG Funding Trust II is a Delaware statutory trust that will:

- sell preferred securities to the public;
- sell common securities to Public Service Enterprise Group Incorporated, or PSEG;
- use the proceeds from these sales to buy an equal principal amount of 8.75% junior subordinated debentures due December 31, 2032 of PSEG; and
- distribute the cash payments it receives from PSEG on the junior subordinated debentures to the holders of the preferred securities and the common securities.

Quarterly Distributions:

For each preferred security that you own, you will receive cumulative cash distributions, accumulating from the date of original issuance at an annual rate of 8.75% of the liquidation amount of $25 per preferred security, on March 31, June 30, September 30 and December 31, of each year, beginning March 31, 2003.

PSEG may defer interest payments on the junior subordinated debentures on one or more occasions, for up to 20 consecutive quarters. If PSEG does defer the payment of interest on the junior subordinated debentures, PSEG Funding Trust II will also defer the payment of distributions on the preferred securities. However, deferred distributions will themselves accumulate interest at an annual rate of 8.75%, to the extent permitted by law.

Optional Redemption:

PSEG Funding Trust II may redeem some or all of the preferred securities on or after December 17, 2007, or all of the preferred securities at any time upon the occurrence of a special event as discussed in this prospectus supplement, at a redemption price equal to $25 per preferred security plus accumulated and unpaid distributions, if any.

Public Service Enterprise Group Incorporated:

PSEG will guarantee the payment by PSEG Funding Trust II of amounts due on the preferred securities as discussed in this prospectus supplement and in the accompanying prospectus.

The preferred securities have been approved for listing on the New York

Stock Exchange under the symbol "PEG PrU," subject to official notice of issuance. Trading of the preferred securities on that exchange is expected to begin within 30 days after the date of original issuance.

Investment in the preferred securities involves certain risks that are described in the sections entitled "Risk Factors" beginning on page S-10 of this prospectus supplement and page 5 of the accompanying prospectus.

	Per Security	Total
Public offering price (1)	$25.00	$180,000,000
Underwriting commissions to be paid by PSEG	$.7875	$5,670,000
Proceeds, before expenses, to PSEG Funding Trust II	$25.00	$180,000,000

(1) Plus accumulated distributions from the date of original issuance, if settlement occurs after that date.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved these securities or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The preferred securities will be ready for delivery in book-entry form only through The Depository Trust Company on or about December 17, 2002.

Joint Book-Running Managers

Merrill Lynch & Co. Morgan Stanley UBS Warburg

Credit Suisse First Boston
Lehman Brothers
Prudential Securities
Wachovia Securities

The date of this prospectus supplement is December 11, 2002.

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You should rely only on the information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus. We and the trust have not, and the underwriters have not, authorized any person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We and the trust are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus supplement or the accompanying prospectus or any document incorporated by reference is accurate only as of its date. PSEG's business, financial condition, results of operations and prospects may have changed since such date.

In this prospectus supplement, references to "PSEG," "we," "us" and "our" refer to Public Service Enterprise Group Incorporated, unless the context indicates that the references are to Public Service Enterprise Group Incorporated and its consolidated subsidiaries, and references to the "trust" are to PSEG Funding Trust II.

PROSPECTUS SUPPLEMENT SUMMARY

This summary highlights important information about PSEG, the trust and this offering. It does not contain all the information that is important to you in connection with your decision to invest in the preferred securities. We encourage you to read this prospectus supplement and the accompanying prospectus in their entirety as well as the information we incorporate by reference before making an investment decision.

Public Service Enterprise Group Incorporated

We are a leading integrated energy company engaged in power generation and wholesale marketing and trading, as well as in the regulated delivery of power and gas. Our domestic merchant power generation and wholesale marketing and trading business, with more than 13,000 megawatts, or MW, of power generation capacity, is one of the largest in the United States and the largest in the Pennsylvania-New Jersey-Maryland Power Pool, or PJM, which is the primary power market in which we participate. Our regulated power and gas distribution business is also one of the largest in the United States and the largest in New Jersey. We are also engaged in power generation and distribution in selected international markets and have a substantial related business focused on providing energy infrastructure financing in developed countries.

The following chart shows PSEG and its principal subsidiaries, Public Service Electric and Gas Company (PSE&G), PSEG Power LLC (Power), PSEG Energy Holdings LLC (Energy Holdings) and PSEG Services Corporation (Services), as well as the principal operating subsidiaries of those subsidiaries:

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                              PSEG
                               |
   ----------------------------------------------------------
   |               |                     |                   |
 PSE&G      --   Power         -- Energy Holdings        Services
            |                  |
            |-- Fossil         |--   Global
            |                  |
            |-- Nuclear        |--  Resources
            |
            |--  ER&T
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The major services and products we provide are offered through the following subsidiaries:

- PSE&G is a regulated public utility supplying electric and gas service to approximately 2.0 million electric customers and approximately 1.6 million gas customers in New Jersey. PSE&G's electric and gas service area is a corridor of approximately 2,600 square miles in which about 70% of the state's population resides. This heavily populated, commercialized and industrialized service area encompasses most of New Jersey's largest municipalities, including its six largest cities. This service territory contains a diversified mix of commerce and industry and its load requirements are almost evenly split among residential, commercial and industrial customers.

- Power is a multi-regional generating and wholesale energy trading company that integrates its generating assets with its wholesale energy trading, fuel supply and risk management operations. It currently owns a portfolio of domestic power generation assets which, as of September 30, 2002, had a total capacity of more than 13,000 MW (including 1,019 MW of fossil generation assets located in Connecticut which were acquired by purchase on December 6, 2002). As a result of New Jersey's deregulation and restructuring of its electric power industry, PSE&G's generation business was transferred to Power in August 2000. Power operates these assets on a competitive merchant basis. Power expects to develop or acquire additional power generation assets opportunistically. Power is currently constructing projects that are expected to increase its capacity by approximately 2,950 MW through 2005, net of planned retirements.

- Global is a subsidiary of Energy Holdings that develops, owns and operates power generation and distribution facilities in selected areas of the worldwide energy market. Global has determined that it will limit future spending to contractual commitments and refocus its strategy from one of accelerated growth to one that places emphasis on increasing the efficiency and returns of its assets. As of September 30, 2002, Global had ownership interests in 32 operating power generation projects, totaling 5,279 MW (2,306 net MW owned), and eight regulated distribution companies.

- Resources is a subsidiary of Energy Holdings that invests primarily in energy-related financial transactions. Resources invests in transactions where its expertise and understanding of the inherent risks and operating characteristics of energy-related assets provide a competitive advantage. As of September 30, 2002, Resources had approximately $3.1 billion in investments.

Competitive Strengths

We believe that we are well positioned to enhance our position as one of the leading integrated energy companies. Our significant competitive strengths include the following:

Relatively stable regulated domestic energy delivery business with strong cash flows

PSE&G has relatively stable cash flows. The stability of PSE&G's business is further enhanced by the relative affluence of its customer base; New Jersey had the fourth-highest per capita personal income in the U.S. in 2000. Unlike some other utilities that are exposed to daily fluctuations in the price at which power can be procured for customers, PSE&G and the other New Jersey utilities can secure all of their customers' longer-term power needs through a centralized process in which a variety of power marketers bid to supply all of New Jersey's power requirements over an annual or longer period. This auction process was completed in February 2002 for the 12-month period from August 1, 2002 to July 31, 2003, and was widely viewed as an efficient, competitive process for regulated power delivery companies, such as PSE&G, to procure a longer-term source of power for their customers at constant prices.

One of the most competitive wholesale power generation asset portfolios in the United States

We believe that Power's portfolio of wholesale power generation plants is well-diversified in terms of fuel type, technology and energy market segments served. We also believe that this diversity reduces the risk associated with market demand cycles and allows us to participate in each segment of the dispatch curve. Power's generation assets are also strategically located near concentrations of customers.

Integrated generation and wholesale marketing and trading

As a complement to our portfolio of wholesale power generation assets, we have an integrated wholesale energy marketing and trading operation with significant technical capabilities and market expertise and a state-of-the-art trading floor. This group, which has been in operation since 1997, centrally controls all of Power's generation assets and provides a competitive wholesale marketing, trading and risk management function that actively participates in all aspects of the energy markets. The integration of our generation operations, fossil fuel procurement and wholesale marketing, trading and risk management capabilities enables us to optimize our mix of financial and physical assets and mitigate the effects of adverse movements in the fuel and electricity markets.

Complementary mix of investments in the rapidly changing global energy markets

In addition to our U.S.-based integrated energy business, we have developed a portfolio of investments that provides us with near-term earnings and supports our long-term growth. Resources' energy-related investments generate cash flow and earnings in the near term, while Global's investments generally have a longer time horizon prior to achieving expected cash flow and earnings. In addition, Resources' passive and lower-risk investments balance the higher risk associated with Global's operating investments.

Business Strategy

We pursue a complementary business mix comprised of regulated energy distribution and unregulated power generation and wholesale energy marketing and trading businesses. We believe our existing critical mass and

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expertise in both regulated and unregulated businesses allows us to expand in both business segments. As key elements of our strategy, we:

Enhance the operating performance of our regulated energy delivery business

We continue to focus on improving the operating performance of our regulated energy delivery business by reducing costs, while continuing to provide safe, highly dependable service to our electric and gas customers. We constantly seek new initiatives to reduce cost and improve performance, such as our recent installation of a state-of-the-art substation in Newark, New Jersey and our phasing in of a sophisticated outage management system. We are also taking a leading role in the establishment of a research and development consortium that will be focused on finding new ways to improve service.

Seek to minimize our exposure to long-term and short-term market risks

We actively manage the risks our businesses face through a risk management framework we developed based on recommendations established by a group of industry experts known as the Group of Thirty. These recommendations are generally considered best practices for the use of derivative instruments. We have a risk management committee that periodically reports to the audit committee of the PSEG board of directors. On a daily basis, our energy marketing and trading operations reports its risk exposure to our independent corporate risk management group, which, in turn, reports to the chief financial officer of PSEG and to the corporate risk management committee. The corporate risk management committee sets risk limits, alert limits and portfolio loss limits for the business. These limits are contained in the procedures and guidelines that detail the actions for implementation of our corporate policy. The chief financial officer of PSEG chairs the risk management committee, which formally meets quarterly to discuss risk matters, but which is also convened on demand when more immediate risk issues arise. The corporate risk management group is charged with measuring, monitoring and reporting both market and credit risk. Our level of risk is computed and reported weekly. We also mark all positions to market daily and stress-test our portfolio on both a daily and a monthly basis to seek to identify potential risks to our portfolio.

Opportunistically develop and acquire additional generation facilities in our target markets

We operate the largest wholesale power generation and wholesale energy marketing business in the PJM power market, which is one of the largest and most efficient power markets in the United States. We pursue a disciplined, opportunistic approach to asset growth through the development of new facilities on existing sites and the acquisition of existing facilities in neighboring regions where we can leverage our expertise with regard to operations, market rules, trading and risk management. Any new development decisions will be based upon a site's location with respect to load centers, priority position in the transmission queue and access to existing fuel supplies.

Please refer to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2002, which is incorporated by reference in this prospectus supplement, for discussions of current factors affecting our business, including credit rating developments and economic and industry considerations.

We are a New Jersey corporation with our principal offices located at 80 Park Plaza, Newark, New Jersey 07101. Our telephone number is (973) 430-7000.

PSEG Funding Trust II

PSEG Funding Trust II is a statutory trust that was recently created under the Delaware Statutory Trust Act and will be governed by an amended and restated trust agreement among the trustees of the trust and us. The trust agreement, as amended, was qualified under the Trust Indenture Act of 1939, as amended. The assets of the trust will consist solely of our junior subordinated debentures. We will hold all of the common securities of the trust.

The principal offices of the trust are located at 80 Park Plaza, Newark, New Jersey 07101 and its telephone number is (973) 430-7000.

The Offering

The following is a brief summary of certain terms of this offering. For a more complete description, see "Description of the Preferred Securities," "Description of the Junior Subordinated Debentures" and "Description of the Guarantee" in this prospectus supplement and "Description of the Preferred Trust Securities," "Description of the Trust Debt Securities" and "Description of the Preferred Securities Guarantee" in the accompanying prospectus.

Issuer .... PSEG Funding Trust II, a Delaware statutory trust, has been created for the purpose of

	acquiring and holding our 8.75% junior subordinated debentures due December 31, 2032 and issuing the preferred securities to the public and common securities to us. Together, the preferred securities and the common securities will evidence the entire beneficial ownership in our junior subordinated debentures.
	The trust has three trustees. The administrative trustee is one of our officers. Wachovia Bank, National Association will act as the property trustee of the trust and Wachovia Trust Company, National Association will act as the Delaware trustee of the trust. The principal offices and telephone number of the trust are the same as ours.
Securities Offered	7,200,000 8.75% Preferred Securities in denominations of $25 with an aggregate liquidation amount of $180,000,000. Each preferred security will represent an undivided beneficial ownership interest in the assets of the trust. Each preferred security will entitle its holder to receive quarterly distributions as described below.
	The trust will invest the proceeds of the preferred securities and of its common securities in an equivalent principal amount of our junior subordinated debentures. The trust will use the payments it receives on the junior subordinated debentures to make the corresponding payments on the preferred securities and its common securities. We will guarantee payments on the preferred securities to the extent described herein and in the accompanying prospectus. Our obligations under the junior subordinated debentures will be subordinated and junior in right of payment to our existing and future Senior Indebtedness and our obligations under the guarantee will be subordinate and junior in right of payment to all of our general liabilities. In addition, both the junior subordinated debentures and the guarantee will effectively be subordinated to existing and future liabilities of our subsidiaries. See the information under the caption "Description of the Junior Subordinated Debentures -- Subordination" in this prospectus supplement for the definition of "Senior Indebtedness."
Distributions	Holders of the preferred securities will be entitled to receive cumulative cash distributions at the annual rate of 8.75%. Distributions on the preferred securities will accumulate from the date of original issuance, and will be paid quarterly in

arrears on March 31, June 30, September 30 and December 31 of each year, beginning March 31, 2003, unless they are deferred as described below.

Distribution Deferral .... We may, on one or more occasions, defer the quarterly interest payments on the junior subordinated debentures for up to 20 consecutive quarterly periods, unless an event of default under the junior subordinated debentures, which we refer to as a debenture event of default, has occurred and is continuing. Interest payments may not be deferred, however, beyond the stated maturity or redemption of the junior subordinated debentures, nor

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may we begin a new interest deferral period until we have paid all accrued interest on the junior subordinated debentures from the previous interest deferral period. If we defer interest payments on the junior subordinated debentures, the trust will also defer distributions on the preferred securities. Any deferred interest on the junior subordinated debentures will accrue additional interest at an annual rate of 8.75%, compounded quarterly, to the extent permitted by law, and, as a result, any deferred distributions on the preferred securities will accumulate additional amounts at an annual rate of 8.75%, compounded quarterly, to the extent permitted by law. During any period in which we defer interest payments on the junior subordinated debentures, we may not do the following, with certain limited exceptions:

o declare or pay any dividends on our capital stock; or

o redeem, purchase, acquire or make a liquidation payment with respect to any of our capital stock.

If we defer payments of interest on the junior subordinated debentures, the junior subordinated debentures will be treated at that time as being issued with original issue discount for United States federal income tax purposes. This means you would be required to accrue interest income on your preferred securities even though you will not be receiving any cash distributions.

	These amounts will be included in your gross income for United States federal income tax purposes. For more information about the tax consequences you may have if payments of distributions are deferred, see "U.S. Federal Income Tax Consequences" in this prospectus supplement.
Redemption	The junior subordinated debentures are scheduled to mature on December 31, 2032. The trust will redeem all of the outstanding preferred securities when the junior subordinated debentures are repaid at maturity.
	We may redeem the junior subordinated debentures in whole or in part on or after December 17, 2007, or prior to December 17, 2007, only in whole at any time within 90 days following the occurrence and continuation of certain changes in tax or investment company laws and regulations, in either case, at 100% of their principal amount plus accrued and unpaid interest. If we redeem any junior subordinated debentures before their maturity, the trust will use the cash it receives on the redemption of the junior subordinated debentures to redeem, on a pro rata basis (except as described in this prospectus supplement), the preferred securities and common securities. These circumstances are more fully described below under the captions "Description of the Trust Preferred Securities--Redemption," in the accompanying prospectus and "Description of the Preferred Securities--Special Event Redemption" and "Description of the Junior Subordinated Debentures--Redemption" in this prospectus supplement.
Dissolution of PSEG Funding Trust II and Distributions of the Junior Subordinated Debentures	We can dissolve the trust at any time, provided the dissolution does not result in a tax event to holders of the preferred securities. If we elect to dissolve the trust, the trust will redeem the preferred securities by distributing the junior subordinated debentures to holders of the preferred securities and common securities on a pro rata basis.

Liquidation Distribution Upon Dissolution	Upon the dissolution and liquidation of the trust not involving the distribution of the junior subordinated debentures, the holders of the preferred securities will be entitled to receive, out of assets held by the trust, subject to the rights of creditors of the trust, if any, distributions in an amount equal to the aggregate liquidation amount of $25 per preferred security, plus accumulated and unpaid distributions to the date of payment. The trust will not make this distribution if the junior subordinated debentures have been distributed to the holders of the preferred securities.
The Guarantee	We will fully and unconditionally guarantee the payments of all amounts due on the preferred securities to the extent the trust has funds available to make those payments. The guarantee does not cover payments when the trust does not have sufficient funds to make payments on the preferred securities. In other words, if we do not make a payment on the junior subordinated debentures, the trust will not have sufficient funds to make payments on the preferred securities, and the guarantee will not obligate us to make those payments on the trust's behalf.
Use of Proceeds	The trust will use the proceeds from the sale of the preferred securities offered hereby and the sale of its common securities to purchase our junior subordinated debentures. We intend to use all the net proceeds from the sale of the junior subordinated debentures to repay short-term indebtedness. We had short-term indebtedness outstanding of $1.7 billion as of September 30, 2002 with a weighted average interest rate of 2.53% per annum.
Listing	The preferred securities have been approved for listing on the New York Stock Exchange, or the NYSE, under the symbol "PEG PrU," subject to official notice of issuance. Trading of the preferred securities on that exchange is expected to begin within 30 days after the date of original issuance. You should understand that the listing of the preferred securities will not ensure that an active trading market will be available or that you will be able to sell your preferred securities when you desire or at all or at the price you originally paid for them. If the junior subordinated debentures are distributed, we will use our best efforts to list the junior subordinated debentures on the NYSE (or any other exchange on which the preferred securities are then listed) in place of the preferred securities.

Form of the Preferred Securities	The preferred securities will be represented by one or more global certificates that will be deposited with and registered in the name of The Depository Trust Company, or DTC. This means that you will not receive a certificate for your preferred securities. For more details, see the information under the caption "Description of the Preferred Securities--Global Preferred Securities" in this prospectus supplement.
Ranking	The preferred securities will generally rank equal to the trust's common securities in priority of payment and therefore the trust will make payments on the preferred securities and common securities based on pro rata allocation, except after a debenture event of default.
	Our junior subordinated debentures will be unsecured and will rank subordinate and junior in right of payment to all of our current and future Senior Indebtedness. The junior subordinated debentures will rank equally with all of our other junior subordinated debentures held by trusts similar

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	to the trust. At September 30, 2002, we and our subsidiaries had consolidated long-term indebtedness of approximately $10.6 billion outstanding and PSEG had $460 million of senior long-term indebtedness outstanding. For more details, see the information under the caption "Description of the Junior Subordinated Debentures--Subordination" in this prospectus supplement.
	Our guarantee will rank equal to any other subordinated guarantees that we may issue or have issued in the past on preferred securities issued by trusts similar to the trust. The guarantee will be unsecured and will rank junior in right of payment to our general liabilities. The junior subordinated debentures and the guarantee will be effectively junior to all existing and future liabilities of our subsidiaries. At September 30, 2002, our subsidiaries had $12.0 billion of indebtedness outstanding.
Risk Factors	Your investment in the preferred securities will involve risks. You should carefully

consider the discussion of risks in "Risk Factors" in this prospectus supplement and the accompanying prospectus before deciding whether an investment in the preferred securities is suitable for you.

RISK FACTORS

Your investment in the preferred securities will involve risk. You should carefully consider the following discussion of risk as well as other information contained and incorporated by reference in this prospectus supplement and the accompanying prospectus in order to evaluate an investment in the preferred securities.

Failure to refinance maturing debt and obtain additional capital at reasonable rates may have an adverse impact

Over the next several years, we and our subsidiaries will be required to refinance maturing debt, and expect to incur additional debt and provide equity to fund subsidiary investment activity. Any inability to obtain required external capital or to extend or replace maturing debt and/or existing agreements at current levels and reasonable interest rates may adversely affect our financial position, results of operations and net cash flows.

The availability and cost of external capital could be affected by each subsidiary's performance as well as by the performance of their respective subsidiaries and affiliates. This could include the degree of structural or regulatory separation between us and our subsidiaries and between PSE&G and its non-utility affiliates and the potential impact of securities ratings on consolidated and unconsolidated credit quality. Additionally, compliance with applicable financial covenants will depend upon our future financial position, results of operations and net cash flows, as to which no assurances can be given.

The current ratings of securities of PSEG reflect the respective views of the rating agencies. There is no assurance that these ratings will continue for any given period of time or that they will not be revised or withdrawn entirely by the rating agencies, if, in their respective judgments, circumstances so warrant. Any downward revisions or withdrawal may adversely effect the market price of our securities and serve to increase our cost of capital.

Failure to comply with a required maximum debt ratio covenant could have an adverse impact

Financial covenants contained in our credit facilities include the ratio of debt (excluding non-recourse project financings and securitization debt and including commercial paper and loans, certain letters of credit and similar instruments) to total capitalization. At the end of any quarterly financial period, such ratio may not be more than 0.70 to 1. As of September 30, 2002, the ratio of debt to capitalization was 0.65 to 1. Accordingly, were we to incur additional indebtedness in sufficient amounts, including by issuances of debt securities in the capital markets, the ratio of debt to total capitalization would exceed the level permitted by our credit facilities.

Our obligations under the junior subordinated debentures and the preferred securities are subordinated

Our obligations under the junior subordinated debentures are unsecured and subordinated. This means that we cannot make any payments of principal (including redemption payments) or interest on the junior subordinated debentures if we default on a payment on our Senior Indebtedness. In addition, if the maturity of the junior subordinated debentures is accelerated, then holders of our Senior Indebtedness will be entitled to be paid in full before we make any payment on the junior subordinated debentures. In the event of our bankruptcy, liquidation or dissolution, our assets would be available to pay obligations under the junior subordinated debentures only after all payments had been made on our Senior Indebtedness.

Our obligations under the preferred securities guarantee are unsecured and will rank in priority of payment:

- junior to all of our other liabilities, except those liabilities made equal with or junior to the preferred securities guarantee by their terms;
- senior to all of our capital stock now outstanding or issued in the future, including our common stock; and
- equally with any other subordinated guarantees that we have issued or may issue with respect to preferred securities issued by trusts similar to the trust.

This means that we cannot make any payments on the preferred securities guarantee if we default on a payment of any of our other liabilities, except those liabilities made equal with or junior to the preferred securities guarantee by their terms. In the event of our bankruptcy, liquidation or dissolution, our assets would be available to pay obligations under the preferred securities guarantee only after all payments had been made on our other liabilities (except those liabilities made equal with or junior to the preferred securities guarantee by their terms).

Neither the junior subordinated debentures nor the preferred securities guarantee will limit our ability or the ability of our subsidiaries to incur additional indebtedness, including indebtedness that ranks senior in priority of payment to the junior subordinated debentures and the preferred securities guarantee.

For more information, see "Description of the Guarantee--Status of the Guarantee" in this prospectus supplement and "Relationship Among the Preferred Trust Securities, the Trust Debt Securities and the Preferred Securities Guarantee" in the accompanying prospectus.

Indebtedness and borrowings by our subsidiaries effectively will be senior to the preferred securities and we are dependent on payments from our subsidiaries to enable us to pay interest on the junior subordinated debentures that are the sole assets of the trust

We are a holding company. Our junior subordinated debentures that we will issue to the trust in connection with the trust's issuance of the preferred securities, as well as the guarantee, will be effectively subordinated to all obligations of our subsidiaries, whether secured or unsecured. As a result, the preferred securities will be structurally subordinated to all existing and future obligations of our subsidiaries, including claims with respect to trade payables. This means that holders of the preferred securities will have a junior position to the claims of creditors of our direct and indirect subsidiaries on the assets and earnings of such subsidiaries. At September 30, 2002, we had consolidated total indebtedness of $13.0 billion, of which $12.0 billion was at the subsidiary level.

We conduct our operations through our subsidiaries, which generate substantially all of our operating income and cash flow. As a result, distributions or advances from our subsidiaries are a major source of funds necessary to meet our debt service and other obligations, including any funds required to make payments of interest on the junior subordinated debentures that represent the sole assets of the trust. Contractual provisions, laws or regulations, as well as any subsidiary's financial condition and operating performance and requirements, may limit our ability to obtain cash required to pay our debt service and other obligations, including payment of interest on our junior subordinated debentures and the related distributions on the preferred securities.

Other than under the guarantee, you have limited enforcement rights with respect to the junior subordinated debentures

Except as described below or in the accompanying prospectus, you, as a holder of preferred securities, will not be able to exercise directly any other rights with respect to our junior subordinated debentures.

The guarantee has been qualified as an indenture under the Trust Indenture Act. The guarantee trustee, Wachovia Bank, National Association, will act as trustee under the guarantee for the purposes of compliance with the provisions of the Trust Indenture Act. The guarantee trustee will hold the guarantee for your benefit if you hold any of the preferred securities.

The guarantee will guarantee the payment of the following:

- any accumulated and unpaid distributions that are required to be paid on the preferred securities, to the extent the trust has funds available for this purpose;

- the redemption price, including all accumulated and unpaid distributions to the date of redemption, of preferred securities that we may have redeemed, to the extent the trust has funds available for this purpose; and

- upon a voluntary or involuntary termination, winding-up or liquidation of the trust, other than in connection with the distribution of our junior subordinated debentures to you, the lesser of (a) the total of the liquidation amount and accumulated and unpaid distributions on the preferred securities to the date of payment to the extent the trust has funds available for this purpose and (b) the amount of assets of the trust remaining available for distribution to holders of the preferred securities in liquidation of the trust.

The holders of a majority in liquidation amount of the preferred securities will have the right to direct the time, method and place of conducting any proceeding for any remedy available to the guarantee trustee or exercise or direct the exercise of any trust or power conferred upon the guarantee trustee under the guarantee. Notwithstanding the above, but only under limited circumstances, holders of the preferred securities may institute a legal proceeding directly against us to enforce their rights under the guarantee without first instituting a legal proceeding against the trust, the guarantee trustee or any other person or entity.

If we default on our obligation to pay principal (including redemption payments) or interest on the junior subordinated debentures, the trust will not have sufficient funds to pay distributions, the redemption price or the liquidation amount of each preferred security. In those circumstances, you will not be able to rely upon the preferred securities guarantee for payment of these amounts because the preferred securities guarantee covers such payment only when the trust has sufficient funds on hand but fails to make such payment.

Instead, you may:

- seek legal redress against us directly or seek other remedies to collect your pro rata share of payments owed; or
- rely on the property trustee to enforce the trust's rights under the junior subordinated debentures.

Our ability to defer distributions has tax consequences for you and may have an adverse effect on the trading price of the preferred securities

So long as no debenture event of default has occurred and is continuing, we may, on one or more occasions, defer interest payments on the junior subordinated debentures as described in this prospectus supplement. See "Description of the Junior Subordinated Debentures--Option to Extend Interest Payment Period" in this prospectus supplement. If we defer interest payments on the junior subordinated debentures while the trust is the holder of the junior subordinated debentures, the trust will defer distributions on the preferred securities to you during any deferral period.

If we defer interest payments on the junior subordinated debentures, you will be required to accrue interest income (as original issue discount, or OID) in respect of the deferred stated interest allocable to your share of the preferred securities for United States federal income tax purposes. As a result, you will include such income in gross income for United States federal income tax purposes prior to the receipt of any cash distributions. In addition, you will not receive cash from the trust related to such income if you dispose of your preferred securities prior to the record date on which distributions of such amounts are made.

We have no current intention of deferring interest payments on the junior subordinated debentures. However, if we exercise our right to do so in the future, the preferred securities may trade at a price that does not fully reflect the value of accrued but unpaid interest on the junior subordinated debentures. If you sell the preferred securities during a deferral period, you may not receive the same return on investment as someone else who continues to hold the preferred securities. In addition, the existence of our right to defer payments of interest on the junior subordinated debentures may mean that the market price for the preferred securities (which represent an undivided beneficial interest in the junior subordinated debentures) may be more volatile than other securities that do not have this right.

See "U. S. Federal Income Tax Consequences" in this prospectus supplement for more information regarding United States federal income tax consequences.

Preferred Securities may be redeemed prior to maturity

The junior subordinated debentures may be redeemed in whole or in part at any time on or after December 17, 2007, or prior to December 17, 2007, in whole, but not in part, within 90 days following the occurrence and continuation of a Special Event, in either case at a redemption price equal to 100% of the principal amount thereof plus any accrued and unpaid interest to the redemption date. The trust will use the cash it receives on any such redemption of the junior subordinated debentures to redeem an equivalent liquidation amount of the preferred securities and common securities of the trust, which we refer to collectively as the trust securities, on a pro rata basis, unless an event of default under the trust agreement has occurred and is continuing, in which case the preferred securities will be redeemed before any common securities.

Distribution of junior subordinated debentures may have an adverse effect on trading prices

We have the right to dissolve the trust at any time if such dissolution and any distribution of the junior subordinated debentures would not result in a taxable event to the holders of the preferred securities. If we dissolve the trust, the trust will be liquidated by distribution of the junior subordinated debentures to holders of the preferred securities and the common securities.

Although we will use our best efforts to list the junior subordinated debentures on the NYSE (or any other exchange or organization on which the preferred securities are then listed), if they are distributed, we cannot assure you that the junior subordinated debentures will be approved for listing or that a liquid trading market for the junior subordinated debentures will develop or be maintained.

We cannot predict the market prices for the junior subordinated debentures that may be distributed. The junior subordinated debentures that you receive on a distribution, or the preferred securities you hold pending such a distribution, may trade at a discount to the price that you paid to purchase the preferred securities.

Because you may receive junior subordinated debentures, you should make an investment decision with regard to the junior subordinated debentures in addition to the preferred securities. You should carefully review all the information regarding the junior subordinated debentures contained in this prospectus supplement and the accompanying prospectus.

Limited voting rights

You will have limited voting rights. In general, unless an event of default under the trust agreement has occurred and is continuing, only we may elect or remove any of the trustees, and in no event may holders of the preferred securities remove the administrative trustee.

See "Information About the Issuers" in the accompanying prospectus and "Description of the Preferred Securities--Voting Rights; Amendment of Trust Agreement" in this prospectus supplement for more information.

USE OF PROCEEDS

The trust will use all of the proceeds from the issuance of the preferred securities and the common securities to purchase our junior subordinated debentures. We intend to use the net proceeds we receive for the junior subordinated debentures to repay short-term indebtedness. We had short-term indebtedness outstanding of $1.7 billion as of September 30, 2002 with a weighted average annualized interest rate of 2.53%.

SELECTED FINANCIAL DATA

The following table sets forth selected financial data for us and our consolidated subsidiaries. Results as of December 31, 2001 and 2000 and for the three years ended December 31, 2001 have been derived from our audited consolidated financial statements and related notes, incorporated by reference in this prospectus supplement and the accompanying prospectus. Results as of December 31, 1999 have been derived from our audited consolidated financial statements and related notes, not incorporated by reference herein. Results as of and for the nine months ended September 30, 2002 and 2001 are derived from our unaudited consolidated financial statements and related notes incorporated by reference this prospectus supplement and in the accompanying prospectus, and in the opinion of management, include all adjustments necessary for a fair presentation of our financial position and results of operations as of and for those periods. The financial data set forth below should be read in conjunction with our "Management's Discussion and Analysis of Financial Condition and Results of Operations" and consolidated financial statements, including the related notes, in the documents incorporated by reference in this prospectus supplement and the accompanying prospectus.

	Nine Months Ended September 30,		
	2002	2001	200
	(Millions of Dollars, exc		
Operating Data:	(unaudited)		
Total Operating Revenues	$ 5,690	$ 5,317	$ 7
Total Operating Expenses	4,747	3,883	5
Operating Income	943	1,434	1
Income before Discontinued Operations, Extraordinary Items and Cumulative Effect of Changes in Accounting Principles	$ 161	$ 584	$
Loss from Discontinued Operations (A)	(41)	(17)	
Extraordinary Item (B)	--	--	
Cumulative Effect of a Change in Accounting Principle (C)	(120)	9	
Net Income	$ --	$ 576	$
Earnings per Share (Basic and Diluted):			
Income before Discontinued Operations, Extraordinary Items and Cumulative Effects of Changes in Accounting Principles	$ 0.78	$ 2.80	$
Net Income (Loss)	$ --	$ 2.76	$
Weighted Average Common Shares Outstanding (000's)	206,552	208,564	208
Dividends Paid per Common Share	$ 1.62	$ 1.62	$

	As of September 30, 2002	2001

Balance Sheet Data:	(unaudited)	
Total Assets	$25,954	$25,430
Commercial Paper and Loans	$ 1,657	$ 1,338
Long-Term Debt due within one year	742	1,185
Long-Term Debt:		
Long-Term Debt	6,902	6,437
Securitization Debt	2,259	2,351
Project Level, Non-Recourse Debt	1,481	1,403
Total Long-Term Debt	10,642	10,191
Subsidiaries Preferred Securities	1,220	760
Common Stockholders' Equity	3,672	4,137
Total Capitalization	$17,933	$17,611

(A) Includes an after tax loss on disposal of discontinued operations recorded in 2002.

(B) Effective April 1, 1999, we discontinued the application of SFAS 71 "Accounting for the Effects of Certain Types of Regulation" for our generation business and recorded an extraordinary charge consisting primarily of a write-down of our nuclear and fossil generation stations. Effective January 1, 2002, we adopted SFAS 145 "Rescission of FASB Statements Nos. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections" and we reclassified a $2 million after-tax loss relating to the early retirement of debt from Extraordinary Items to a component of Other Deductions for the nine months ended September 30, 2001 in accordance with the new standard.

(C) Relates to the adoption of SFAS 142 "Goodwill and other Intangible Assets" on January 1, 2002 and the adoption of SFAS 133 "Accounting for Derivative Instruments and Hedging Activities" on January 1, 2001.

CAPITALIZATION

The following table sets forth the consolidated capitalization of PSEG and its subsidiaries as of September 30, 2002 and as adjusted to give effect to the sale of the preferred securities offered hereby, the issuance of the junior subordinated debentures and the application of the estimated net proceeds therefrom. The following data should be read in conjunction with the consolidated financial statements and notes thereto of PSEG and its subsidiaries incorporated herein by reference.

Commercial Paper and Loans	
Long-Term Debt due within one year	

Long-Term Debt:	
Long-term debt	
Securitization debt	
Project level, non-recourse debt	
Total long-term debt	
Subsidiaries' Preferred Securities:	
Preferred stock without mandatory redemption	
Participating equity preference securities	
Guaranteed preferred beneficial interests in subordinated debentures	
Total subsidiaries' preferred securities	
Common Stockholders' Equity:	
Common stock (233,432,138 shares issued, actual and as adjusted)	
Treasury stock, at cost (26,118,590 shares actual and as adjusted)	
Retained earnings	
Accumulated other comprehensive loss	
Total common stockholders' equity	
Total capitalization	

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(1) Does not reflect the incurrence of $245 million of long-term debt issued pursuant to a private placement in October 2002, the proceeds of which were used to reduce short-term debt.

(2) Does not reflect the issuance of 17,250,000 shares of common stock in November 2002, the proceeds of which were used to reduce short-term debt.

RATIO OF EARNINGS TO FIXED CHARGES

Our ratio of earnings to fixed charges for each of the periods indicated is as follows:

	For the Nine Months Ended September 30,		Y	
	2002	2001	1997	19
Ratio of Earnings to Fixed Charges	1.2x	2.1x	2.4x	2.

The ratios of earnings to fixed charges were computed by dividing earnings by fixed charges. For this purpose, earnings consist of pre-tax income from continuing operations excluding extraordinary items, plus the amount of fixed charges adjusted to exclude: the amount of any interest capitalized during the period; and the actual amount of any preferred stock dividend requirements of majority-owned subsidiaries which were included in such fixed charges amount but not deducted in the determination of pre-tax income. Fixed charges consist of: interest, whether expensed or capitalized; amortization of debt discount, premium and expense; an estimate of interest implicit in rentals; and preferred securities dividend requirements of subsidiaries and preferred stock dividends, increased to reflect our pre-tax earnings requirement.

ACCOUNTING TREATMENT

The financial statements of PSEG Funding Trust II will be reflected in our consolidated financial statements, with the preferred securities shown on our balance sheet under the caption "Guaranteed Preferred Beneficial Interests in Subordinated Debentures." The footnotes to our consolidated financial statements will reflect that the sole asset of the trust will be our junior subordinated debentures. Distributions on the preferred securities will be reflected as a charge to our consolidated income, identified as "Preferred Dividends of Subsidiary," whether paid or accumulated.

DESCRIPTION OF THE PREFERRED SECURITIES

The following summary of some of the terms and provisions of the preferred securities supplements the description of the terms and provisions of the preferred trust securities set forth in the accompanying prospectus under the heading "Description of the Preferred Trust Securities." To the extent that any of the terms and provisions of the preferred trust securities described in this prospectus supplement are inconsistent with the description of the preferred securities in the accompanying prospectus, the description of the preferred securities in this prospectus supplement replaces the description in the accompany prospectus.

Distributions

The preferred securities represent undivided beneficial interests in the assets of the trust, the sole assets of which will be the junior subordinated debentures. Distributions on the preferred securities are cumulative and will accumulate from the date of original issuance at the annual rate of 8.75% of the liquidation amount of $25 per preferred security. Distributions will be payable quarterly in arrears on March 31, June 30, September 30 and December 31 of each year, commencing March 31, 2003. Distributions not paid on a quarterly payment date will accumulate additional distributions (to the extent permitted by law) compounded quarterly, at the annual rate of 8.75%. The term "distributions," as used in this prospectus supplement, includes any of these additional distributions. The amount of distributions payable for any period will be computed on the basis of a 360-day year of twelve 30-day months. Distributions on the preferred securities will be payable to holders as they appear on the books and records of the Trust on the relevant record dates. As long as the preferred securities remain in book-entry form only, the record dates will be one business day prior to the relevant payment date. With respect to preferred securities not in book-entry form, the record dates will be the fifteenth calendar day prior to the relevant payment date, whether or not a business day.

So long as no debenture event of default has occurred and is continuing, we have the right at any time and from time to time to defer the payment of interest by extending the interest payment period on the junior subordinated debentures for up to 20 consecutive quarters. However, no extension period may extend beyond the maturity or any redemption date of the junior subordinated debentures. As a consequence, quarterly distributions on the preferred securities would be deferred by the trust during any extension period, but the amount of distributions to which holders of the preferred securities would be entitled would continue to accumulate at 8.75%, compounded quarterly. During any extension period, we may not declare or pay any dividends on, or redeem, purchase, acquire, or make a liquidation payment with respect to, any shares of our capital stock. Prior to the termination of any extension period, we may shorten or further extend the interest payment period on the junior subordinated debentures, provided that no extension period may exceed 20 consecutive quarters or extend beyond the maturity or any redemption date of the junior subordinated debentures. Upon the termination of any extension period and the payment of all amounts then due, we may elect to begin a new extension period. We have no current intention of exercising our right to defer payments of interest by extending the interest payment period on the junior subordinated debentures.

The preferred securities will be issued in the form of one or more global preferred securities and The Depository Trust Company, or DTC, or any successor depositary will act as depositary for the preferred securities. See "--Global Preferred Securities" below for a description of DTC and its procedures. Payments on the preferred securities represented by a global security will be made in immediately available funds to DTC, as the depositary for the preferred securities. In the event that the preferred securities are issued in certificated form, the payment of distributions and payments on redemption or liquidation will be payable, the transfer of the preferred securities

will be registerable and preferred securities will be exchangeable at the corporate office of the property trustee, or at the offices of any other paying agent or transfer agent appointed by the administrative trustee; provided, however, that the payment of distributions shall be made by check mailed to the address of the holder of such preferred securities.

Redemption

Upon the payment of the junior subordinated debentures at maturity or upon redemption as provided in the indenture, the proceeds from such payment will be applied by the property trustee to redeem a like amount of trust securities on a pro rata basis, upon not less than 30 nor more than 60 days' notice, at a redemption price equal to the aggregate liquidation amount of the trust securities to be redeemed plus accumulated and unpaid distributions to the date of redemption, unless an event of default under the trust agreement has occurred and is continuing, in which case the preferred securities will be redeemed before any common securities. See "Description of the Junior Subordinated Debentures--Redemption."

"Like amount" means:

o with respect to a redemption of the trust securities, trust securities having an aggregate liquidation amount equal to the aggregate principal amount of junior subordinated debentures to be paid under the indenture, and

o with respect to a distribution of junior subordinated debentures to holders of trust securities in connection with a dissolution of the trust, junior subordinated debentures having an aggregate principal amount equal to the aggregate liquidation amount of the trust securities in exchange for which junior subordinated debentures are distributed.

Special Event Redemption

If a Tax Event or an Investment Company Event, each of which we refer to as a Special Event, has occurred and is continuing, we have the right to redeem the junior subordinated debentures, in whole but not in part, and therefore cause a mandatory redemption of the preferred securities, in whole but not in part, at the redemption price within 90 days following the occurrence of the Special Event.

"Tax Event" means that we have received an opinion of counsel experienced in such matters to the effect that, as a result of any amendment to, or change in, the laws of the United States or any political subdivision or taxing authority of or within the United States affecting taxation, or as a result of any official administrative pronouncement or judicial decision interpreting or applying such laws or regulations, which amendment or change is effective or such pronouncement or decision is announced on or after the date of original issuance of the preferred securities, there is more than an insubstantial risk that:

- the trust is, or will be, subject to federal income tax with respect to interest on the junior subordinated debentures,
- interest payable by us on the junior subordinated debentures is not, or will not be, deductible by us for federal income tax purposes, or
- the trust is, or will be, subject to more than a de minimis amount of other taxes, duties, assessments or other governmental charges.

"Investment Company Event" means the occurrence of a change in law or regulation or a change in interpretation or application of law or regulation by any legislative body, court, governmental agency or regulatory authority to the effect that the trust is or will be considered an "investment company" that is required to be registered under the Investment Company Act of 1940, which change in law becomes effective on or after the date of original issuance of the preferred securities.

Subordination of Common Securities

Payments on the trust securities will be made pro rata based on the respective aggregate liquidation amounts of the common securities and the preferred securities. If an event of default has occurred and is continuing with respect to the junior subordinated debentures, no payments will be made on any common securities unless payment in full in cash of all accumulated and unpaid distributions on all outstanding preferred securities for all distribution periods terminating on or prior to that time, or in the case of a dissolution or redemption, the full amount of the redemption price or liquidation distribution on all outstanding preferred securities shall have been made or provided for, and all funds available to the property trustee shall first be applied to the payment in full in cash of all payments on all outstanding preferred securities then due and payable.

If an event of default has occurred and is continuing with respect to the junior subordinated debentures, the holder of the common securities will be deemed to have waived any right to act with respect to the event of default until the effect of the event of default has been cured, waived or otherwise eliminated with respect to the preferred securities. Until the event of default has been cured, waived or otherwise eliminated, the property trustee shall act solely on behalf of the holders of the preferred securities and not on behalf of us, as holder of the common securities, and only the holders of the preferred securities will have the right to direct the property trustee to act on their behalf.

Distribution of Junior Subordinated Debentures

At any time, we may, in our sole discretion, dissolve the trust and, after satisfaction of liabilities of creditors of the trust, cause a like amount of junior subordinated debentures to be distributed to the holders of the preferred securities in liquidation of the trust upon 30 days' prior notice to the holders of the preferred securities. However, in order to do so, we will be required to deliver to the trustees an opinion of nationally recognized tax counsel that the distribution will not be a taxable event to the owners of the preferred securities for federal income tax purposes. In addition, the junior subordinated debentures may be distributed to holders of preferred securities in certain other circumstances as described under "Description of the Preferred Trust Securities--Liquidation Distribution Upon Dissolution" in the accompanying prospectus.

Liquidation Amount

The amount payable on the preferred securities in the event of the dissolution and liquidation of the trust is $25 per preferred security plus accumulated and unpaid distributions to the date of payment, unless, in connection with the dissolution and liquidation, the junior subordinated debentures are distributed to the holders of the preferred securities.

Trust Agreement Event of Default; Notice

An event of default with respect to the junior subordinated debentures will constitute a "trust agreement event of default" with respect to the preferred securities. Within 90 days after the occurrence of any trust agreement event of default actually known to the property trustee, the property trustee will send notice of it to the holders of the trust securities, the administrative trustee and us, unless it has been cured or waived. We and the administrative trustee are required to file annually with the property trustee a certificate as to whether or not we are in compliance with all the conditions and covenants applicable to us under the trust agreement.

Under the trust agreement, if the property trustee has failed to enforce its rights under the trust agreement or the indenture to the fullest extent permitted by law and subject to the terms of the trust agreement and the indenture, any holder of the preferred securities may institute a legal proceeding directly against us to enforce the property trustee's rights under the trust agreement or the indenture with respect to junior subordinated debentures having an aggregate principal amount equal to the aggregate liquidation amount of the preferred securities of such holder without first instituting a legal proceeding against the property trustee or any other person. To the extent that any action under the indenture is entitled to be taken by the holders of at least a specified percentage of the principal amount of the junior subordinated debentures, holders of that specified percentage of the preferred securities may take that action if it is not taken by the property trustee. If a trust agreement event of default

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attributable to our failure to pay principal of or premium, if any, or interest on the junior subordinated debentures has occurred and is continuing, then each holder of preferred securities may institute a legal proceeding directly against us for enforcement of payment to that holder, all as provided in the indenture.

If an event of default has occurred and is continuing with respect to the junior subordinated debentures, the preferred securities will have a preference over the common securities with respect to the payment of distributions and amounts payable on redemption and liquidation. See "--Subordination of Common Securities" above and "Description of Preferred Trust Securities--Liquidation Distribution upon Dissolution" in the accompanying prospectus.

Mergers, Consolidations, Amalgamations or Replacements of the Trust

The trust may not merge with or into, consolidate, amalgamate, or be replaced by, or convey, transfer or lease its properties and assets as an entirety or substantially as an entirety to any corporation or other entity, except as described below or in "Description of Preferred Trust Securities--Liquidation Distribution upon Dissolution" in the accompanying prospectus. The trust may, at our request, with the consent of the administrative trustee and without the consent of the holders of the trust securities, merge with or into, consolidate, amalgamate, or be replaced by a trust organized under the laws of any state, as long as

- the successor entity either
  - expressly assumes all of the obligations of the trust with respect to the trust securities, or
  - substitutes for the trust securities other securities substantially similar to the trust securities (the "successor securities") so long as the successor securities rank the same as the trust securities with respect to the payment of distributions and payments upon redemption, liquidation and otherwise;
- we appoint a trustee of the successor entity with the same powers and duties as the property trustee with respect to the junior subordinated debentures;
- the successor securities are listed, or any successor securities will be listed upon notification of issuance, on any national securities exchange or other organization on which the trust securities are then listed or quoted;
- the merger, consolidation, amalgamation, replacement, conveyance, transfer or lease does not cause the rating of the preferred securities (including any successor securities) to be downgraded, placed under surveillance or review or withdrawn by any nationally recognized statistical rating organization;
- the merger, consolidation, amalgamation, replacement, conveyance, transfer or lease does not adversely affect the rights, preferences and privileges of the holders of the trust securities (including any successor securities) in any material respect;
- the successor entity has a purpose substantially similar to that of the trust;
- prior to the merger, consolidation, amalgamation, replacement, conveyance, transfer or lease, we and the property trustee have received a legal opinion stating that
  - such merger, consolidation, amalgamation, replacement, conveyance, transfer or lease does not adversely affect the rights, preferences and privileges of the holders of the trust securities (including any successor securities) in any material respect, and
  - following the merger, consolidation, amalgamation, replacement, conveyance, transfer or lease neither the trust nor the successor entity will be required to register as an investment company under the Investment Company Act of 1940, and the trust (or the successor entity) will continue to be classified as a grantor trust for United States federal income

tax purposes; and

- we or any permitted successor assignee own all of the common securities of the successor entity and guarantee the obligations of the successor entity under the successor securities at least to the extent provided by the related guarantee and trust agreement.

The trust will not, except with the consent of all holders of the trust securities, consolidate, amalgamate, merge with or into, or be replaced by, or convey, transfer or lease its properties and assets substantially as an entirety to, any other entity, or permit any other entity to consolidate, amalgamate, merge with or into, or replace it if that consolidation, amalgamation, merger, replacement, conveyance, transfer or lease would cause the trust or the successor entity not to be classified as a grantor trust for United States federal income tax purposes.

Voting Rights; Amendment of Trust Agreement

Except as provided below and under "--Mergers, Consolidations, Amalgamations or Replacements of the Trust" above and "Description of the Preferred Securities Guarantee--Amendments and Assignment" in the accompanying prospectus and as otherwise required by law and the trust agreement, the holders of the trust securities will have no voting rights.

The trust agreement may be amended from time to time by us and the trustees, without the consent of the holders of the trust securities, (1) to cure any ambiguity, defect or inconsistency or (2) to make any other change that does not adversely affect in any material respect the interests of the holders of the preferred securities.

The trust agreement may be amended by us and the trustees in any other respect, with the consent of the holders of a majority in aggregate liquidation amount of the outstanding preferred securities, except to

- change the amount, timing or currency or otherwise adversely affect the method of payment of any distribution or liquidation distribution;
- restrict the right of a holder of any preferred securities to institute suit for enforcement of any distribution, redemption price or liquidation distribution;
- change the purpose of the trust;
- authorize the issuance of any additional beneficial interests in the trust;
- change the redemption provisions;
- change the conditions precedent for us to elect to dissolve the trust and distribute the junior subordinated debentures to the holders of the preferred securities or
- affect the limited liability of any holder of the preferred securities,

which amendment requires the consent of each affected holder of the preferred securities.

No amendment may be made without receipt by the trust of a legal opinion stating that the amendment will not affect the trust's status as a grantor trust for United States federal income tax purposes or its exemption from regulation as an investment company under the Investment Company Act of 1940.

The trustees shall not

- direct the time, method and place of conducting any proceeding for any remedy available to a trustee under the indenture or executing any trust or power conferred on that trustee with respect to the junior subordinated debentures,

- waive any past default under the indenture,

- exercise any right to rescind or annul an acceleration of the principal of the junior subordinated debentures or

- consent to any amendment or modification of the indenture, where consent shall be required,

without, in each case, obtaining the prior consent of the holders of a majority in aggregate liquidation amount of all outstanding preferred securities; provided, however, that where a consent under the indenture would require the consent of each affected holder of junior subordinated debentures, no consent shall be given by the property trustee without the prior consent of each holder of the preferred securities. The trustees shall not revoke any action previously authorized or approved by a vote of the holders of the preferred securities except by subsequent vote of those holders. The property trustee shall notify all holders of preferred securities of any notice received from the

trustee under the indenture as a result of the trust being the holder of the junior subordinated debentures. In addition to obtaining the consent of the holders of the preferred securities prior to taking any of these actions, the trustees shall obtain a legal opinion stating that the trust will not be classified as an association taxable as a corporation or a partnership for United States federal income tax purposes as a result of that action and will continue to be classified as a grantor trust for United States federal income tax purposes.

Any required consent of holders of preferred securities may be given at a meeting of holders of the preferred securities convened for that purpose or pursuant to written consent without a meeting and without prior notice. The property trustee will cause a notice of any meeting at which holders of preferred securities are entitled to vote, to be given to each holder of record of preferred securities in the manner set forth in the trust agreement.

Notwithstanding that holders of preferred securities are entitled to vote or consent under certain circumstances, any preferred securities that are owned by us, the trustees or any affiliate of ours or any trustee shall, for purposes of a vote or consent, be treated as if they were not outstanding.

Global Preferred Securities

The preferred securities will initially be issued in fully registered global form that will be deposited with, or on behalf of, DTC. Global preferred securities may be issued only in fully registered form and unless and until a global preferred security is exchanged in whole or in part for the individual preferred securities represented thereby, the depositary holding the global preferred security may transfer the global preferred security only to its nominee or successor depositary or vice versa and only as a whole.

The following provisions will apply to the depositary arrangements with respect to global preferred securities and junior subordinated debentures issued in global form upon dissolution and liquidation of the trust.

So long as DTC or its nominee is the registered owner of a global security, DTC or its nominee, as the case may be, will be considered the sole holder of the preferred securities represented by such global security for all purposes under the trust agreement. Except as provided below, owners of beneficial interests in a global security will not be entitled to have preferred securities represented by the global security registered in their names, will not receive or be entitled to receive physical delivery of preferred securities in certificated form and will not be considered the owners or holders thereof under the trust agreement. The laws of some states require that certain purchasers of securities take physical delivery of such securities in certificated form; those laws may limit the transferability of beneficial interests in a global security.

If

- o we notify the trustees of the trust in writing that DTC is unwilling, unable or ineligible to continue as depositary and a successor depositary is not appointed by us within 60 days;

- o we determine, in our sole discretion, not to have any preferred securities represented by one or more global securities; or

- o an event of default under the trust agreement has occurred and is continuing,

then we will issue individual preferred securities in certificated form in exchange for the relevant global securities.

In any such instance, an owner of a beneficial interest in a global security will be entitled to physical delivery of individual preferred securities in certificated form of like tenor and rank, equal in principal amount to such beneficial interest and to have such preferred securities in certificated form registered in its name.

The following is based on information furnished by DTC:

Registered Owner. The preferred securities will be issued as fully registered securities in the name of Cede & Co., which is DTC's partnership nominee. The applicable trustee will deposit the global securities with the depositary. The deposit with the depositary and its registration in the name of Cede & Co. will not change the nature of the actual purchaser's ownership interest in the preferred securities.

DTC's Organization. DTC is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of that law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934.

DTC is owned by a number of its direct participants and the New York Stock Exchange, Inc., the American Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Direct participants include securities brokers and dealers, banks, trust companies, clearing corporations and some other organizations that directly participate in DTC. Other entities may access DTC's system by clearing transactions through or maintaining a custodial relationship with direct participants. The rules applicable to DTC and its participants are on file with the SEC.

DTC's Activities. DTC holds securities that its participants deposit with it. DTC also facilitates the settlement among participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerized book-entry changes in participants' accounts. Doing so eliminates the need for physical movement of securities certificates.

Participant's Records. Except as otherwise provided in this prospectus or a prospectus supplement, purchases of preferred securities must be made by or through a direct participant, which will receive a credit for the preferred securities on the depositary's records. The purchaser's interest is in turn to be recorded on the participant's records. Actual purchasers will not receive written confirmation from the depositary of their purchase, but they generally receive confirmations, along with periodic statements of their holdings, from the participants through which they entered into the transaction.

Transfers of interests in the global securities will be made on the books of the participants on behalf of the actual purchasers. Certificates representing the interest in preferred securities will not be issued unless the use of global securities is suspended.

The depositary has no knowledge of the actual purchasers of global securities. The depositary's records only reflect the identity of the direct participants, who are responsible for keeping account of their holdings on behalf of their customers.

Notices among the Depositary, Participants and Actual Purchasers. Notices and other communications by the depositary, its participants and the actual purchasers will be governed by arrangements among them, subject to any legal requirements in effect. Any redemption notices will be sent to DTC. If less than all of the securities within an issue are being redeemed, DTC's practice is to determine by lot the amount of the interest of each direct participant in such issue to be redeemed.

Voting Procedures. Neither DTC nor Cede & Co. will give consents for or vote the global securities. The depositary generally mails an omnibus proxy to us just after the applicable record date. That proxy assigns Cede & Co.'s voting rights to the direct participants to whose accounts the preferred securities are credited at that time.

Payments. Payments in respect of the preferred securities will be delivered to the depositary. DTC's practice is to credit direct participants' accounts on the applicable payment date unless it has reason to believe that it will not receive payment on that date. Payments by participants to actual purchasers will be governed by standing instructions and customary practices, as is the case with securities held for customers in bearer form or registered in "street name." Those payments will be the responsibility of that participant and not the depositary, the applicable trustee or us, subject to any legal requirements in effect at that time.

We are responsible for payments to the applicable trustee who is responsible for paying it to the depositary. The depositary is responsible for disbursing those payments to direct participants. The participants are responsible for disbursing payments to the actual purchasers.

DTC may discontinue providing its services as securities depositary with respect to the preferred securities at any time by giving reasonable notice to the applicable paying agent or us. Under such circumstances, in the event that a successor securities depositary is not appointed, preferred security certificates are required to be printed and delivered.

We may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depositary). In that event, preferred security certificates will be printed and delivered.

The information in this section concerning DTC and DTC's book-entry system has been obtained from sources (including DTC) that we believe to be reliable, but we take no responsibility for the accuracy thereof.

None of any underwriter, the trustees, any applicable paying agent or us will have any responsibility or liability for any aspect of the records relating to or payments made on account of beneficial interests in a global security, or for maintaining, supervising or reviewing any records relating to such beneficial interests.

DESCRIPTION OF THE JUNIOR SUBORDINATED DEBENTURES

The following summary of some of the terms and provisions of the junior subordinated debentures supplements the description of the terms and provisions of the trust debt securities set forth in the accompanying prospectus under the heading "Description of the Trust Debt Securities." To the extent that any of the terms and provisions of the junior subordinated debentures described in this prospectus supplement are inconsistent with the description of the trust debt securities in the accompanying prospectus, the description of the junior subordinated debentures in this prospectus supplement replaces the description in the accompanying prospectus. The junior subordinated debentures will be issued pursuant to an indenture, which we refer to as the "indenture," to be dated as of December 17, 2002, between us and Wachovia Bank, National Association, the junior subordinated debenture trustee. The junior subordinated debentures will be unsecured and will rank subordinate and junior in right of payment to all our Senior Indebtedness.

Interest Rate; Maturity

The trust will invest the proceeds from the issuance of the preferred securities, together with the consideration paid by us for the common securities, in the junior subordinated debentures. The junior subordinated debentures will be issued as a series of debentures under the indenture. The junior subordinated debentures will mature on December 31, 2032. The junior subordinated debentures will bear interest at the annual rate of 8.75%, payable quarterly in arrears on March 31, June 30, September 30 and December 31 of each year, commencing March 31, 2003. Interest which is accrued and unpaid after a quarterly payment date will bear additional interest (to the extent permitted by law) at the annual rate of 8.75%, compounded quarterly. The term "interest" includes quarterly interest payments and interest on quarterly interest payments in arrears, as applicable. In addition, during any time that the property trustee is the holder of the junior subordinated debentures, we will be required to pay additional amounts on the junior subordinated debentures as may be necessary in order that the distribution amount then due and payable by the trust on the preferred securities shall not be reduced as a result of any additional taxes, duties and other governmental charges to which the trust has become subject as a result of a Tax Event. The interest payment provisions for the junior subordinated debentures correspond to the distribution provisions of the preferred securities.

Option to Extend Interest Payment Period

Under the indenture, we have the right to defer payments of interest by extending the interest payment period for the junior subordinated debentures for up to 20 consecutive quarterly periods. However, such period of deferral may not extend beyond the maturity date or earlier redemption date of the junior subordinated debentures. We refer to any such period of deferral as an "extension period." We can extend or shorten an existing extension period. At the end of an extension period, we will be obligated to pay all interest then accrued and unpaid (together with interest on those accrued and unpaid amounts to the extent permitted by applicable law). Upon the termination of any extension period and the payment of all amounts then due, we can elect to begin a new extension period. We will be required to give notice to the junior subordinated debenture trustee and cause the junior subordinated debenture trustee to give notice to the holders of the junior subordinated debentures of our election to begin an extension period, or any shortening or extension of a period in advance of the applicable record date.

Redemption

The junior subordinated debentures may be redeemed at our option (1) at any time on or after December 17, 2007, in whole or in part, and (2) prior to December 17, 2007, in whole, but not in part, within 90 days following the

occurrence and continuance of a Special Event, in any such case at a redemption price equal to 100% of the principal amount to be redeemed, plus accrued and unpaid interest, including any compounded interest and any additional interest, if any, to the date of redemption.

Subordination

Payments on the junior subordinated debentures will be subordinated to the prior payment in full of all amounts payable on our Senior Indebtedness.

"Senior Indebtedness" is defined in the indenture as the principal of and premium, if any, and unpaid interest on

o our indebtedness (including indebtedness of others guaranteed by us), whether outstanding on the date of the indenture or created later, incurred, assumed or guaranteed, for money borrowed, unless the terms of that indebtedness provide that it is not senior or prior in right of payment to the junior subordinated debentures, and

o renewals, extensions, modifications and refundings of that indebtedness.

Upon any payment or distribution of our assets or securities, upon our dissolution or winding-up or total or partial liquidation or reorganization, whether voluntary or involuntary, or in bankruptcy, insolvency, receivership or other proceedings, all amounts payable on Senior Indebtedness (including any interest accruing on the Senior Indebtedness after the commencement of a bankruptcy, insolvency or similar proceeding) will be paid in full before the holders of the junior subordinated debentures will be entitled to receive from us any payment of principal of, premium, if any, or interest on, the junior subordinated debentures or distributions of any assets or securities.

No direct or indirect payment by or on our behalf of principal of, premium, if any, or interest on, the junior subordinated debentures will be made if there is

- a default in the payment of all or any portion of any Senior Indebtedness, or

- any other default pursuant to which the maturity of Senior Indebtedness has been accelerated and, in either case, the required notice has been given to the junior subordinated debenture trustee and the default has not been cured or waived by or on behalf of the holders of the Senior Indebtedness.

If the junior subordinated debenture trustee or any holder of the junior subordinated debentures receives any payment of the principal of, premium, if any, or interest on, the junior subordinated debentures when that payment is prohibited and before all amounts payable on Senior Indebtedness are paid in full, then that payment will be received and held in trust for the holders of Senior Indebtedness and will be paid to the holders of the Senior Indebtedness remaining unpaid to the extent necessary to pay the Senior Indebtedness in full.

Nothing in the indenture limits the right of the junior subordinated debenture trustee or the holders of the junior subordinated debentures to take any action to accelerate the maturity of the junior subordinated debentures or to pursue any rights or remedies against us, as long as all Senior Indebtedness is paid before holders of the junior subordinated debentures are entitled to receive any payment from us of principal of, premium, if any, or interest on, the junior subordinated debentures.

Upon the payment in full of all Senior Indebtedness, the holders of the junior subordinated debentures will be subrogated to the rights of the holders of the Senior Indebtedness to receive payments from us or distributions of our assets made on the Senior Indebtedness until the junior subordinated debentures are paid in full.

Events of Default

The following are events of default under the indenture with respect to the junior subordinated debentures:

- we do not pay interest on a junior subordinated debenture within 30 days of its due date (other than the deferral of interest payments during an extension period);

- we do not pay the principal of a junior subordinated debenture on its due date;

- we remain in breach of a covenant in respect of the junior subordinated debentures for 60 days after we receive written notice of default stating we are in breach; or

- we file for bankruptcy or a court appoints a custodian or orders our liquidation under any bankruptcy law or certain other events of bankruptcy, insolvency or reorganization occur.

In case an event of default has occurred and is continuing, other than one relating to bankruptcy, insolvency or reorganization affecting us in which case the principal of, premium, if any, and any interest on, all of the junior subordinated debentures shall become immediately due and payable, the junior subordinated debenture trustee or the holders of at least 25% in aggregate principal amount of the junior subordinated debentures may declare the principal, together with interest accrued thereon, of all the junior subordinated debentures to be due and payable. If neither the junior subordinated debenture trustee nor the holders make that declaration then, if the junior subordinated debentures are held by the trust, the holders of at least 25% in aggregate liquidation amount of the preferred securities shall have the right to make that declaration by written notice to us and the junior subordinated debenture trustee. The holders of at least a majority in aggregate principal amount of the junior subordinated debentures, by notice to the junior subordinated debenture trustee, can rescind an acceleration, but if the declaration was made by the holders of the preferred securities, the holders of at least a majority in aggregate liquidation amount of the preferred securities must consent to the rescission of the acceleration. We will be required to furnish to the junior subordinated debenture trustee an annual statement as to our compliance with all conditions and covenants under the indenture and the junior subordinated debentures and as to any event of default.

Distribution of the Junior Subordinated Debentures

If junior subordinated debentures are distributed to the holders of the preferred securities upon the dissolution and liquidation of the trust, the junior subordinated debentures will be issued in integral multiples of $25. We anticipate that any junior subordinated debentures distributed to holders of preferred securities will be distributed in the form of one or more global securities and that DTC, or any successor depositary for the preferred securities, would act as depositary for the junior subordinated debentures. The depositary arrangements for the junior subordinated debentures would be substantially similar to those in effect for the preferred securities. Neither we, the junior subordinated debenture trustee nor any paying agent or any of our other agents will have any responsibility or liability for any aspect of the records relating to or payments made on account of beneficial ownership interests in a global security for such junior subordinated debentures or for maintaining, supervising or reviewing any records relating to those beneficial ownership interests. For a description of DTC and the terms of the depositary arrangements relating to payments, transfers, voting rights, redemption and other notices and other matters, see "Description of the Preferred Securities--Global Preferred Securities." Payments on the junior subordinated debentures represented by a global security will be made in immediately available funds to DTC, as the depositary for the junior subordinated debentures. In the event that the junior subordinated debentures are issued in certificated form, principal and interest will be payable, the transfer of the junior subordinated debentures will be registrable and the junior subordinated debentures will be exchangeable for junior subordinated debentures of other authorized denominations of a like aggregate principal amount, at the corporate office of the junior subordinated debenture trustee in Newark, New Jersey, or at the offices of any other paying agent or transfer agent appointed by us; provided, however, that payment of interest will be made by check mailed to the address of the persons entitled to the payment or by wire transfer. In addition, if the junior subordinated debentures are issued in certificated form, the record dates for payment of interest will be the 15th calendar day prior to the relevant payment date, whether or not a business day. If the junior subordinated debentures are distributed to the holders of the preferred securities upon the dissolution and liquidation of the trust, we will use our best efforts to list the junior subordinated debentures on the NYSE.

DESCRIPTION OF THE GUARANTEE

The following summary of some of the terms and provisions of the guarantee supplements the description of the terms and provisions of the preferred securities guarantee set forth in the accompanying prospectus under the heading "Description of the Preferred Securities Guarantee." To the extent that any of the terms and provisions of the guarantee described in this prospectus supplement are inconsistent with the description of the preferred securities guarantee in the accompanying prospectus, the description of the guarantee in this prospectus supplement replaces the description in the accompany prospectus. Wachovia Bank, National Association will act as guarantee trustee under the guarantee. The guarantee trustee will hold the guarantee for the benefit of the holders of the preferred securities.

General

We will irrevocably agree, to pay in full, to the holders of the preferred securities, the guarantee payments set forth below (except to the extent previously paid), as and when due, regardless of any defense, right of set-off or counterclaim which the trust may have or assert. The following payments, to the extent not paid by the trust, will be subject to the guarantee:

- any accumulated and unpaid distributions required to be paid on the preferred securities, to the extent that that trust has funds available therefor,
- the redemption price, to the extent that the trust has funds available therefor, and
- upon a voluntary or involuntary termination, winding-up or liquidation of the trust (unless the junior subordinated debentures are redeemed or distributed to holders of the preferred securities in accordance with their terms), the lesser of
  - the aggregate of the liquidation amount of $25 per preferred security plus all accumulated and unpaid distributions on the preferred securities to the date of payment, to the extent the trust has funds available therefor, and
  - the amount of assets of the trust remaining available for distribution to holders of the preferred securities upon a dissolution and liquidation of the trust.

Our obligation to make a guarantee payment may be satisfied by direct payment by us of the required amounts to the holders of the preferred securities or by causing the trust to pay those amounts to the holders. While our assets will not be available pursuant to the guarantee for the payment of any distribution, liquidation distribution or redemption price on any preferred securities if the trust does not have funds available therefor as described above, we have agreed under the trust agreement to pay all expenses of the trust except its obligations under the trust securities of the trust.

No single document executed by us in connection with the issuance of the preferred securities will provide for our full, irrevocable and unconditional guarantee of the preferred securities. It is only the combined operation of our obligations under the guarantee, the trust agreement, the junior subordinated debentures and the indenture that has the effect of providing a full, irrevocable and unconditional guarantee of the trust's obligations under the preferred securities. See "Relationship Among the Preferred Trust Securities, the Trust Debt Securities and the Preferred Securities Guarantee" in the accompanying prospectus.

Status of the Guarantee

The guarantee will constitute our unsecured obligation and will rank subordinate and junior in right of payment to all of our general liabilities. The trust agreement provides that each holder of preferred securities by acceptance thereof agrees to the subordination provisions and other terms of the guarantee. The guarantee will constitute a guarantee of payment and not of collection (i.e., the guaranteed party may institute a legal proceeding directly against us to enforce its rights under the guarantee without first instituting a legal proceeding against any other person or entity). The guarantee will not be discharged except by payment of the guarantee payments in full to the extent not previously paid or upon distribution to the holders of the preferred securities of the junior subordinated debentures pursuant to the trust agreement.

U.S. FEDERAL INCOME TAX CONSEQUENCES

The following summary describes the material United States federal income tax consequences of the purchase, ownership and disposition of the preferred securities and the junior subordinated debentures. This summary is based upon the Internal Revenue Code of 1986, as amended (the "Tax Code"), United States Treasury regulations (the "Treasury regulations"), and administrative and judicial rulings and decisions now in effect, all of which are subject to change or differing interpretations, possibly with retroactive effect. In particular, either the Internal Revenue Service (the "IRS") or the courts could disagree with the conclusions contained in this summary.

This summary deals only with preferred securities and junior subordinated debentures held as capital assets and does not deal with persons in special tax situations, for example, financial institutions, banks, insurance companies, regulated investment companies, dealers in securities or currencies, persons holding preferred securities or junior subordinated debentures as a position in a "straddle" or in a "hedging" or "conversion" transaction for tax purposes, or persons whose functional currency is not the United States dollar. This summary also does not deal with holders other than original purchasers who purchase the preferred securities at their original purchase price.

Before purchasing the preferred securities or junior subordinated debentures, you should consult your own tax advisor concerning the application of United States federal income tax laws to your particular situation as well as any consequences of the purchase, ownership and disposition of the preferred securities and junior subordinated debentures arising under any other tax laws of the United States or other taxing jurisdictions.

For purposes of this summary, a "U.S. Holder" is a beneficial owner of a preferred security or junior subordinated debenture that is for United States federal income tax purposes:

- a citizen or resident of the United States,
- a corporation or partnership, or other entity treated as a corporation or partnership for United States federal income tax purposes, created or organized in or under the laws of the United States, any state thereof or the District of Columbia, unless otherwise provided by Treasury regulations,
- an estate the income of which is subject to United States federal income taxation regardless of its source, or

- a trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have the authority to control all substantial decisions of the trust, or certain electing trusts in existence on August 20, 1996, to the extent provided in Treasury regulations,

in each case except as otherwise provided under the provisions of an applicable tax treaty. A "Non-U.S. Holder" is a beneficial owner of a preferred security or junior subordinated debenture that is not a U.S. Holder.

Classification of the preferred securities and the junior subordinated debentures

In connection with the issuance of the preferred securities, Ballard Spahr Andrews & Ingersoll, LLP, tax counsel to PSEG ("Tax Counsel"), will render its opinion that, under current law and assuming full compliance with the terms of the junior subordinated debentures and related documents, the junior subordinated debentures will be classified for United States federal income tax purposes as our indebtedness.

Tax Counsel will also render its opinion to the effect that, under current law and assuming full compliance with the terms of the trust agreement, the indenture, the guarantee and related documents, the trust will be classified for United States federal income tax purposes as a grantor trust and will not be subject to tax as a partnership, an association that is taxable as a corporation, or a publicly traded partnership taxable as a corporation. Accordingly, for United States federal income tax purposes, you will generally be treated as the owner of an undivided interest in the assets of the trust, specifically, the junior subordinated debentures. You will therefore be required to include in income for United States federal income tax purposes your allocable share of interest and other income paid, accrued, or realized with respect to the junior subordinated debentures. The portion of the purchase price for a preferred security that is allocable to prior accrued distributions may be treated as offsetting a portion of the interest income from the next scheduled payment or accrual on the junior subordinated debentures. Further, corporate U.S. Holders of the preferred securities will not be entitled to a dividends received deduction for any income from the preferred securities.

By acceptance of a preferred security, each holder covenants for United States federal income tax purposes to treat the junior subordinated debentures as our indebtedness and to treat the preferred securities as evidence of a beneficial ownership interest in the junior subordinated debentures through a grantor trust.

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Interest income and original issue discount

Under the Treasury regulations relating to original issue discount ("OID"), a debt instrument is deemed to be issued with OID if there is more than a "remote" contingency that periodic stated interest payments due on the instrument will not be timely paid. Our exercise of the option to defer payments of stated interest on the junior subordinated debentures would generally prevent us from:

- paying a dividend on our shares of capital stock; or
- redeeming, purchasing, acquiring or making a liquidation payment on any of our capital stock.

We therefore believe that the likelihood of our exercising the option to defer payment of stated interest is remote within the meaning of the Treasury regulations. Accordingly, based upon the advice of Tax Counsel, we intend to take the position that the junior subordinated debentures will not be deemed to be issued with OID. Based on this position, provided we have not exercised our option to defer the payment of interest on the junior subordinated debentures, stated interest payments on the junior subordinated debentures will be includible in your ordinary income at the time that those payments are received or accrued, in accordance with your regular method of accounting for federal income tax purposes. However, the IRS could interpret the Treasury regulations relating to OID in a manner contrary to the position we intend to take. If the IRS succeeded in asserting the contrary position, the OID rules would generally require you to include interest on the junior subordinated debentures in your taxable income as it accrues rather than when you receive payment, even though you may use the cash method of accounting for federal income tax purposes.

Exercise of deferral option

Under the Treasury regulations, if we exercise our option to defer the payment of interest on the junior subordinated debentures, then the junior subordinated debentures will be treated as redeemed and reissued for OID purposes. Accordingly, the sum of the remaining interest payments on the junior subordinated debentures would be treated as OID, which you would be required to accrue and include in taxable income on an economic accrual basis over the remaining term of the junior subordinated debentures, without regard to the actual timing of interest payments under the junior subordinated debentures and without regard to your regular method of accounting for federal income tax purposes. The amount of OID income includible in your taxable income would be determined on the basis of a constant yield method over the remaining term of the junior subordinated debentures and the actual receipt of future payments of stated interest on the junior subordinated debentures would no longer be separately reported as taxable income. The total amount of OID that would accrue during the deferred interest payment period would be approximately equal to the amount of the cash payment due at the end of that period. Any OID included in income would increase your adjusted tax basis in your preferred securities and junior subordinated debentures, and your actual receipt of cash interest payments would reduce that adjusted tax basis.

Receipt of junior subordinated debentures or cash upon liquidation of the trust

We will have the right at any time to dissolve the trust and cause the junior subordinated debentures to be distributed on a proportionate basis to you, subject to our receipt of an opinion of counsel that the distribution of the junior subordinated debentures would not result in a taxable event to holders of the preferred securities. Under current law, such a distribution, for United States federal income tax purposes, would be treated as a nontaxable event to you, and you would receive an aggregate tax basis in the junior subordinated debentures received equal to your aggregate tax basis in your preferred securities. Your holding period in the junior subordinated debentures so received in dissolution of the trust would include the period during which the preferred securities were held by you. If, despite the delivery of an opinion of counsel that the dissolution, resulting liquidation and distribution of junior subordinated debentures would not result in a taxable event to holders of the preferred securities, the trust is ultimately characterized for United States federal income tax purposes as an association taxable as a corporation at the time of its dissolution and liquidation, the distribution of junior subordinated debentures would be a taxable event to holders of the preferred securities and your holding period in the junior subordinated debentures would commence on the day following your acquisition of the junior subordinated debentures.

If you receive junior subordinated debentures in exchange for your preferred securities, you would continue to accrue interest, and OID if any, in respect of those junior subordinated debentures in the manner described above. Similarly, if the junior subordinated debentures are redeemed for cash and the proceeds of the redemption are distributed to you in redemption of your preferred securities, the redemption would be treated as a sale of the preferred securities in which gain or loss is recognized as described below.

Sale of preferred securities or junior subordinated debentures

If you sell your preferred securities or junior subordinated debentures, or otherwise dispose of them in a taxable transaction (including a redemption for cash), then you will recognize gain or loss in an amount equal to the difference between:

- the amount realized on the sale, exclusive of the amount equal to any unpaid interest on the junior subordinated debentures not previously included in your income, which excluded amount will be taxed as interest in the manner described above, and

- your adjusted tax basis in the preferred securities or junior subordinated debentures at the time of disposition.

For these purposes, your adjusted tax basis generally will equal the initial purchase price that you paid for the preferred securities, minus any amounts paid for accrued and unpaid distributions that are offset against interest or OID income, plus any accrued and unpaid distributions that you were required to treat as OID income, minus any cash payments you received in respect of accrued OID. Your gain or loss on the sale of preferred securities or junior subordinated debentures generally will be capital gain or loss, and will be long-term capital gain or loss if you have held this investment for more than one year at the time of disposition. Preferential rates of tax may apply to capital gains recognized upon the disposition of investments held for more than one year or more than five years. The deductibility of capital losses is subject to significant limitations.

Taxation of non-U.S. holders

The rules governing the United States federal income taxation of non-U.S. Holders are complex, and the following discussion is intended only as a summary of these rules. If you are a non-U.S. Holder, we urge you to consult with your own tax advisor to determine the impact of United States federal, state, local, and foreign tax laws, including any tax return filing and other reporting requirements, with respect to your investment in the preferred securities or the junior subordinated debentures.

If you are a non-U.S. Holder, you will not be subject to United States federal income tax on payments of principal, premium (if any) or interest (including OID, if any) on the preferred securities or the junior subordinated debentures, or upon the sale, exchange, redemption, retirement or other disposition of the preferred securities or the junior subordinated debentures, if:

- you do not own directly or indirectly 10% or more of the voting equity of PSEG;

- you are not a controlled foreign corporation that is related to us through stock ownership;

- you are not a bank receiving interest described in Section 881(c)(3)(A) of the Tax Code;

- your income and gain in respect of the preferred securities and junior subordinated debentures is not effectively connected with the conduct of a United States trade or business;

- we or the applicable paying agent (the "Withholding Agent") have received from you a properly executed, applicable IRS Form W-8BEN or substantially similar form in the year in which a payment of interest, OID, principal, premium, or other disposition proceeds occurs, or in a preceding calendar year to the extent provided for in the instructions to the applicable IRS Form W-8BEN; and

- in the case of gain upon the sale, exchange, redemption, retirement or other disposition of the preferred securities or junior subordinated debentures recognized by an individual non-U.S. Holder, you were present in the United States for less than 183 days during the calendar year in which the gain was recognized and certain other conditions were met.

The IRS Form W-8BEN or substantially similar form must be signed by you under penalties of perjury certifying that you are a non-U.S. Holder and providing your name and address. You must inform the Withholding Agent of any change in the information on this statement within 30 days of the change, and complete and submit a new IRS Form W-8BEN or substantially similar form with the updated information. If you hold the preferred securities or junior subordinated debentures through a securities clearing organization or other qualified financial institution, the organization or institution may provide a signed statement to the Withholding Agent. However, in that case, the signed statement must generally be accompanied by a copy of the executed IRS Form W-8BEN or substantially similar form that you provided to the organization or institution.

If you are a non-U.S. Holder claiming benefits under an income tax treaty, you should be aware that you may be required to obtain a taxpayer identification number and to certify your eligibility under the applicable treaty's limitations on benefits article in order to comply with the applicable certification requirements. Treasury regulations also provide rules to determine whether, for purposes of determining the applicability of a tax treaty, interest paid to a non-U.S. Holder that is an entity should be treated as paid to the entity or to those holding ownership interests in that entity, and whether the entity or the holders in the entity are entitled to benefits under the tax treaty.

In general, a non-U.S. Holder will be subject to regular United States federal income tax in the same manner as a U.S. Holder with respect to its investment in the preferred securities and the junior subordinated debentures, if that investment is effectively connected with the non-U.S. Holder's conduct of a trade or business in the United States. In addition, a corporate non-U.S. Holder that receives income that is or is deemed effectively connected with a trade or business in the United States may also be subject to the branch profits tax under Section 884 of the Tax Code at the rate of 30% (or lower treaty rate). This tax is payable in addition to regular United States federal corporate income tax. To obtain an exemption from withholding on preferred securities or junior subordinated debentures effectively connected with your conduct of a trade or business in the United States, you must generally supply to the withholding agent an applicable IRS Form W-8ECI.

Proposed Legislation

On January 24, 2002, Representative Charles B. Rangel introduced legislation in the U.S. House of Representatives which, if enacted in its current form, would in some cases disallow interest deductions for United States federal income tax purposes for interest paid on debentures with certain similarities to the junior subordinated debentures. This legislation is proposed to be effective for instruments issued on or after the date of enactment of such legislation. Consequently, as drafted, this legislation would not affect the preferred securities or the junior subordinated debentures or otherwise result in a Tax Event as described under "Description of the Preferred Securities--Special Event Redemption." However, there can be no assurance that the proposed legislation, final legislation or any other future legislative proposals will not adversely affect our ability to deduct interest on the junior subordinated debentures or otherwise affect the tax treatment of the transactions described in this prospectus supplement. Such change could, if applicable to the junior subordinated debentures or preferred securities, give rise to a Tax Event, which would permit us to cause a redemption of the preferred securities and create a taxable event for holders of preferred securities.

Information reporting and backup withholding

Information reporting and backup withholding at the applicable statutory rate may apply to interest and other payments to you under the circumstances discussed below. Amounts withheld under backup withholding are generally not an additional tax and may be refunded or credited against your federal income tax liability, provided that you furnish the required information to the IRS.

If you are a U.S. Holder, you may be subject to backup withholding when you receive interest or OID payments on the preferred securities or junior subordinated debentures, or proceeds upon the sale, exchange, redemption, retirement or other disposition of the preferred securities or junior subordinated debentures. In general, you can avoid this backup withholding by properly executing under penalties of perjury an IRS Form W-9 or substantially similar form that provides:

- your correct taxpayer identification number, and

- a certification that you are exempt from backup withholding because (a) you are a corporation or come within another enumerated exempt category, (b) you have not been notified by the IRS that you are subject to backup withholding or (c) you have been notified by the IRS that you are no longer subject to backup withholding.

If you do not provide your correct taxpayer identification number on the IRS Form W-9 or substantially similar form, you may be subject to penalties imposed by the IRS. Unless you have established on a properly executed IRS Form W-9 or substantially similar form that you are a corporation or come within another enumerated exempt category, interest and other payments on the preferred securities or junior subordinated debentures paid to you during the calendar year, and the amount of tax withheld, if any, will be reported to you and to the IRS. It is anticipated that income on the preferred securities and junior subordinated debentures will be reported to U.S. Holders on Form 1099-INT or, if we exercise our option to defer any payment of interest, Form 1099-OID, and mailed to U.S. Holders by January 31 following each calendar year.

If you are a non-U.S. Holder, the amount of interest and OID paid to you on the preferred securities or junior subordinated debentures during each calendar year, and the amount of tax withheld, if any, will generally be reported to you and to the IRS. This information reporting requirement applies regardless of whether you were subject to withholding or whether withholding was reduced or eliminated by an applicable tax treaty. Also, interest and OID paid to you on the preferred securities or the junior subordinated debentures may be subject to backup withholding, unless you properly certify your non-U.S. Holder status on an IRS Form W-8BEN or substantially similar form in the manner described above. Similarly, information reporting and backup withholding will not apply to proceeds you receive upon the sale, exchange, redemption, retirement or other disposition of the preferred securities or junior subordinated debentures, if you properly certify that you are a non-U.S. Holder on an IRS Form W-8BEN or substantially similar form.

ERISA CONSIDERATIONS

General fiduciary obligations

Fiduciaries of a pension, profit-sharing or other employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974, ERISA, must consider whether:

- their investment in the preferred securities satisfies the diversification requirements of ERISA;
- the investment is prudent in light of possible limitations on the marketability of our preferred securities and junior subordinated debentures;
- they have authority to acquire the preferred securities under the applicable governing instrument and Title I of ERISA; and
- the investment is otherwise consistent with their fiduciary responsibilities.

Trustees and other fiduciaries of an ERISA plan may incur personal liability for any loss suffered by the plan on account of a violation of their fiduciary responsibilities. In addition, these fiduciaries may be subject to a civil penalty of up to 20% of any amount recovered by the plan on account of a violation. Fiduciaries of any IRA, Roth IRA, Keogh Plan or other qualified retirement plan subject to the prohibited transaction provisions of the Tax Code but not subject to Title I of ERISA, referred to as "non-ERISA plans," should consider that a plan may only make investments that are authorized by the appropriate governing instrument. Fiduciaries should consult their own legal advisors if they have any concern as to whether the investment is consistent with the foregoing criteria.

Prohibited transactions

Fiduciaries of ERISA plans and persons making the investment decision for an IRA or other non-ERISA plan should consider the application of the prohibited transaction provisions of ERISA and the Tax Code in making their investment decision. Sales and other transactions between an ERISA plan or a non-ERISA plan, and persons related to it are prohibited transactions. The particular facts concerning the sponsorship, operations and other investments of an ERISA plan or non-ERISA plan may cause a wide range of other persons to be treated as disqualified persons or parties in interest with respect to it. A prohibited transaction, in addition to imposing potential personal liability upon fiduciaries of ERISA plans, may also result in the imposition of an excise tax under the Tax Code or a penalty under ERISA upon the disqualified person or party in interest with respect to the plan. If the disqualified person who engages in the transaction is the individual on behalf of whom an IRA or Roth IRA is maintained or his beneficiary, the IRA or Roth IRA may lose its tax-exempt status and its assets may be deemed to have been distributed to the individual in a taxable distribution on account of the prohibited transaction, but no excise tax will be imposed. Fiduciaries should consult their own legal advisors as to whether the ownership of the preferred securities or junior subordinated debentures involves a prohibited transaction.

Special fiduciary and prohibited transactions consequences

The Department of Labor, which has administrative responsibility over ERISA plans as well as non-ERISA plans, has issued a regulation defining "plan assets." The regulation generally provides that when an ERISA or non-ERISA plan acquires a security that is an equity interest in an entity and that security is neither a "publicly offered security" nor a security issued by an investment company registered under the Investment Company Act of 1940, the ERISA plan's or non-ERISA plan's assets include both the equity interest and an undivided interest in each of the underlying assets of the entity, unless it is established either that the entity is an operating company or that equity participation in the entity by benefit plan investors is not significant.

The regulation defines a publicly offered security as a security that is "widely held," "freely transferable" and either part of a class of securities registered under the Securities Exchange Act of 1934, or sold under an effective registration statement under the Securities Act of 1933, provided the securities are registered under the Securities Exchange Act of 1934 within 120 days after the end of the fiscal year of the issuer during which the offering occurred. The preferred securities have been registered under the Securities Exchange Act of 1934.

The regulation provides that a security is "widely held" only if it is part of a class of securities that is owned by 100 or more investors independent of the issuer and of one another. However, a security will not fail to be "widely held" because the number of independent investors falls below 100 subsequent to the initial public offering as a result of events beyond the issuer's control. We believe that, immediately after this offering, the preferred securities should be owned by 100 or more investors independent of us and of each other, and therefore that the "widely held" requirement for qualification as publicly offered securities should be met.

The regulation provides that whether a security is "freely transferable" is a factual question to be determined on the basis of all relevant facts and circumstances. The regulation further provides that, where a security is part of an offering in which the minimum investment is $10,000 or less, some restrictions on transfer ordinarily will not, alone or in combination, affect a finding that these securities are freely transferable. The restrictions on transfer enumerated in the regulation as not affecting that finding include:

- any restriction on or prohibition against any transfer or assignment which would result in a termination or reclassification for federal or state tax purposes, or would otherwise violate any state or federal law or court order;

- any requirement that advance notice of a transfer or assignment be given to the issuer and any requirement that either the transferor or transferee, or both, execute documentation setting forth representations as to compliance with any restrictions on transfer which are among those enumerated in the regulation as not affecting free transferability, including those described in the preceding clause of this sentence;

- any administrative procedure which establishes an effective date, or an event prior to which a transfer or assignment will not be effective; and

- any limitation or restriction on transfer or assignment which is not imposed by the issuer or a person acting on behalf of the issuer.

We believe that at present there exist no other facts or circumstances limiting the transferability of the preferred securities which are not included among those enumerated as not affecting their free transferability under the regulation, and we do not expect or intend to impose in the future, or to permit any person to impose on our behalf, any limitations or restrictions on transfer which would not be among the enumerated permissible limitations or restrictions.

The discussion herein of ERISA is general in nature and is not intended to be complete. Any fiduciary of a plan, governmental plan, church plan or a foreign plan considering an investment in the preferred securities should consult with its legal advisors regarding the consequences and advisability of this investment.

UNDERWRITING

Subject to the terms and conditions of an underwriting agreement dated the date of this prospectus supplement, the trust has agreed to sell to each underwriter named below and each of the underwriters, for whom Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co. Incorporated and UBS Warburg LLC are acting as representatives, has severally, but not jointly, agreed to purchase from the trust, the number of preferred securities set forth opposite the name of each underwriter below.

Underwriter	Number of Preferred Securities
Merrill Lynch, Pierce, Fenner & Smith Incorporated	835,000
Morgan Stanley & Co. Incorporated	835,000
UBS Warburg LLC	835,000
Credit Suisse First Boston Corporation	835,000
Lehman Brothers Inc.	835,000
Prudential Securities Incorporated	835,000
Wachovia Securities, Inc.	835,000
ABN AMRO Incorporated	55,000
Banc of America Securities LLC	55,000
CIBC World Markets Corp.	55,000
Deutsche Bank Securities Inc.	55,000
Gerard Klauer Mattison & Co., Inc.	55,000
J.P. Morgan Securities Inc.	55,000
Janney Montgomery Scott LLC	55,000
Jefferies & Company, Inc.	55,000

Legg Mason Wood Walker, Incorporated	55,000
McDonald Investments Inc., a KeyCorp Company	55,000
Quick & Reilly, Inc.	55,000
RBC Dain Rauscher Inc.	55,000
Stifel, Nicolaus & Company, Incorporated	55,000
TD Waterhouse Investor Services, Inc.	55,000
US Bancorp Piper Jaffray Inc.	55,000
Wells Fargo Van Kasper, LLC	55,000
The Williams Capital Group, L.P.	55,000
Advest, Inc.	35,000
BB&T Capital Markets, A division of Scott and Stringfellow, Inc.	35,000
Robert W. Baird & Co. Incorporated	35,000
M.R. Beal & Company	35,000
William Blair & Company, L.L.C.	35,000
Fahnestock & Co. Inc.	35,000
Ferris, Baker Watts, Incorporated	35,000
C.L. King & Associates, Inc.	35,000
Mesirow Financial, Inc.	35,000
Morgan Keegan & Company, Inc.	35,000
NatCity Investments, Inc.	35,000
SWS Securities, Inc.	35,000
Total	7,200,000

In the underwriting agreement, the underwriters have agreed, subject to the terms and conditions set forth in the underwriting agreement, to purchase all the preferred securities offered hereby if any of the preferred securities are purchased. In the event of a default by an underwriter, the underwriting agreement provides that the purchase commitments of the non-defaulting underwriters may be increased or the underwriting agreement may be terminated.

We and the trust have agreed with the underwriters to indemnify them against certain civil liabilities, including liabilities under the Securities Act of 1933, or to contribute with respect to payments that the underwriters may be required to make.

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The underwriters are offering the preferred securities, subject to prior sale, when, as and if issued and accepted by them, subject to approval of legal matters by their counsel, including the validity of the preferred securities, and other conditions contained in the underwriting agreement, such as the receipt by the underwriters of officer's certificates and legal opinions. The underwriters reserve the right to withdraw, cancel or modify offers to the public and to reject orders in whole or in part.

The underwriters and their affiliates have in the past and may in the future engage in transactions with, or perform services for, us and our affiliates in the ordinary course of business. Certain of the underwriters or their affiliates are lenders under certain of our revolving credit facilities. Affiliates of Wachovia Securities, Inc. serve as Delaware trustee and property trustee of the trust and will serve as trustee under the indenture pursuant to which the junior subordinated debentures will be issued and as guarantee trustee under the guarantee.

The underwriters have advised us that they propose to offer the preferred securities to the public initially at $25 per preferred security and to dealers at that price less a concession not in excess of $.50 per preferred security.

The underwriters may allow, and the dealers may reallow, a discount not in excess of $.45 per preferred security to other dealers. After the initial public offering, the public offering price, concession and discount may be changed.

Because the proceeds from the sale of the preferred securities and the common securities will be used to purchase our junior subordinated debentures, we have agreed to pay to the underwriters an underwriting commission of $.7875 per preferred security (or a total of $5,670,000).

We will pay all expenses, estimated to be approximately $250,000, associated with the offer and sale of the preferred securities.

Before this offering, there was no established public trading market for the preferred securities. The preferred securities have been approved for listing on the NYSE, subject to official notice of issuance. Trading of the preferred securities on the NYSE is expected to begin within 30 days after the date of original issuance. In order to meet all of the requirements for listing the preferred securities on the NYSE, the underwriters have agreed to sell the preferred securities to a minimum of 400 beneficial owners. The representatives have advised us that they intend to make a market in the preferred securities. However, the representatives are not obligated to do so and may discontinue market making at any time without notice. No assurance is given that a liquid trading market for the preferred securities will be available.

We and the trust have agreed, during the period beginning from the date of the underwriting agreement and continuing to and including the earlier of (i) the date on which the distribution of the preferred securities ceases, as determined by the representatives, or (ii) 30 days from the settlement date, not to offer, sell, contract to sell or otherwise dispose of any preferred securities, any other preferred securities of the trust or any securities of PSEG which are substantially similar to the junior subordinated debentures, the preferred securities guarantee or the preferred securities or any securities convertible into or exchangeable into or representing the right to receive any of those securities, without the prior written consent of the representatives.

It is expected that delivery of the preferred securities will be made against payment therefor on or about the date specified in the last paragraph of the cover page of this prospectus supplement.

In connection with the sale of the preferred securities, rules of the Securities and Exchange Commission permit the underwriters to engage in transactions that stabilize the price of the preferred securities. These transactions may include purchases for the purpose of fixing or maintaining the price of the preferred securities.

The underwriters may create a short position in the preferred securities in connection with this offering. That means they may sell a larger number of preferred securities than is shown on the cover page of this prospectus supplement. If they create a short position, the underwriters may purchase preferred securities in the open market to reduce the short position.

If the underwriters purchase the preferred securities to stabilize the price or to reduce their short position, the price of the preferred securities could be higher than it might be if they had not made such purchases. The underwriters make no representation or prediction about any effect that the purchases may have on the price of the preferred securities.

The underwriters may suspend any of these activities at any time.

The representatives may also impose a penalty bid on certain underwriters and selling group members. This means that, if the representatives purchase preferred securities in the open market to reduce the underwriters' short position or to stabilize the price of the preferred securities, it may reclaim the amount of the selling concession from the underwriters and the selling group members who sold those preferred securities as part of this offering.

LEGAL MATTERS

Certain legal matters with respect to the offering of the preferred securities and the junior subordinated debentures will be passed on for us by James T. Foran, Esq., our Associate General Counsel, and by Ballard Spahr Andrews & Ingersoll, LLP, special tax counsel to PSEG, and for the underwriters by Sidley Austin Brown & Wood LLP. Sidley Austin Brown & Wood LLP will rely upon the opinion of Mr. Foran as to all matters of New Jersey law. Several matters of Delaware law with respect to the validity of the preferred securities offered hereby will be passed upon for us and the trust by Richards, Layton & Finger, P.A.

EXPERTS

The financial statements as of December 31, 2001 and 2000, and for each of the three years in the period ended December 31, 2001 and the related financial statement schedule, incorporated by reference in the prospectus dated December 5, 2002 from the Company's Current Report on Form 8-K dated November 22, 2002, have been audited by Deloitte & Touche LLP, independent auditors, as stated in their report, which is incorporated herein by reference, and have been so incorporated in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

PROSPECTUS

PUBLIC SERVICE ENTERPRISE GROUP INCORPORATED

PSEG FUNDING TRUST II
PSEG FUNDING TRUST III
PSEG FUNDING TRUST IV

By this prospectus, we offer up to

$1,000,000,000

of

Public Service Enterprise Group Incorporated
Common Stock, Preferred Stock,
Stock Purchase Contracts, Stock Purchase Units and
Debt Securities

and

PSEG Funding Trust II
PSEG Funding Trust III
PSEG Funding Trust IV

Preferred Trust Securities
Guaranteed as described in this prospectus by

Public Service Enterprise Group Incorporated

We will provide the specific terms of each series or issue of securities in supplements to this prospectus. You should read this prospectus and the applicable supplement carefully before you invest.

See "Risk Factors" beginning on page 5 for certain risks you should consider.

The date of this prospectus is December 5, 2002.

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we and PSEG Funding Trust II, PSEG Funding Trust III and PSEG Funding Trust IV each of which we refer to as, a "Trust" and, collectively as the "Trusts," filed with the SEC using a "shelf" registration process. Under this shelf process, we and/or the Trusts may, from time to time, sell the securities described in this prospectus or combinations thereof in one or more offerings with a maximum aggregate initial offering price of up to $1,000,000,000.

This prospectus provides a general description of the securities we may offer. Each time we sell securities, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. You should read both this prospectus and any prospectus supplement together with additional information described under "Where You Can Find More Information."

In this prospectus, unless the context indicates otherwise, the words and terms "PSEG," "the company," "we," "our," "ours" and "us" refer to Public Service Enterprise Group Incorporated and its consolidated subsidiaries.

We may use this prospectus to offer from time to time:

- shares of our common stock, without par value;

- shares of our preferred stock, without par value, which may be convertible into our common stock;

- stock purchase contracts to purchase shares of our common stock;

- our unsecured debt securities, which may include senior, subordinated and trust debt securities and which may be convertible into our common stock. In this prospectus, we refer to the debt securities, which may include senior debt securities, subordinated debt securities and trust debt securities, as the "debt securities;"

- stock purchase units, consisting of a stock purchase contract and our debt securities, a Trust's preferred securities or debt obligations of third parties, including United States Treasury securities, that are pledged to secure the stock purchase unit holders' obligations under the stock purchase contracts.

The Trusts may also use this prospectus to offer from time to time their respective preferred securities, which we refer to in this prospectus as the "preferred trust securities." We will execute a preferred securities guarantee covering the preferred trust securities of each Trust and will guarantee each Trust's obligations under the preferred trust securities as described herein.

We sometimes refer to our common stock, preferred stock, stock purchase contracts, stock purchase units, the debt securities, the preferred trust securities and the preferred securities guarantee collectively as the "securities."

For more detailed information about the securities, you should also review the exhibits to the registration statement, which were either filed with the registration statement or incorporated by reference to other SEC filings.

INFORMATION ABOUT THE ISSUERS

Public Service Enterprise Group Incorporated

We are an integrated energy and energy services company engaged in power generation, regulated delivery of power and gas service and wholesale energy marketing and trading. We are an exempt public utility holding company under the Public Utility Holding Company Act of 1935 and neither own nor operate any physical properties. Through our subsidiaries, we are one of the leading providers of energy and energy-related services in the nation. We have four direct, wholly-owned subsidiaries:

- Public Service Electric and Gas Company ("PSE&G"), which is an operating public utility company engaged principally in the transmission and distribution of electric energy and gas service in New Jersey;

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- PSEG Power LLC ("Power"), which is a multi-regional independent electric generation and wholesale energy marketing and trading company;

- PSEG Energy Holdings LLC ("Energy Holdings"), which participates nationally and internationally in energy-related lines of business through its subsidiaries; and

- PSEG Services Corporation ("Services"), which provides administrative and support services to us and our subsidiaries.

We are a New Jersey corporation with our principal offices located at 80 Park Plaza, Newark, New Jersey 07101. Our telephone number is (973) 430-7000.

Ratios of Earnings to Fixed Charges

Our ratios of earnings to fixed charges for each of the periods indicated is as follows:

	(unaudited) Nine Months Ended September 30, 2002	Years Ended December 31,				
		1997	1998	1999	2000	2
Ratios of Earnings to Fixed Charges	1.17	2.43	2.80	3.07	2.60	2

The ratios of earnings to fixed charges were computed by dividing earnings by fixed charges. For this purpose earnings consist of pre-tax income from continuing operations excluding extraordinary items, plus the amount of fixed charges adjusted to exclude: the amount of any interest capitalized during the period; and the actual amount of any preferred stock dividend requirements of majority-owned subsidiaries which were included in such fixed charges amount but not deducted in the determination of pre-tax income. Fixed charges consist of: interest, whether expensed or capitalized; amortization of debt discount, premium and expense; an estimate of interest implicit in rentals; and preferred securities dividend requirements of subsidiaries and preferred stock dividends, increased to reflect our pre-tax earnings requirement.

Ratios of Earnings to Combined Fixed Charges and Preference Dividends

Our ratios of earnings to combined fixed charges and preference dividends for each of the periods indicated is the same as our ratios of earnings to fixed charges.

The Trusts

Each Trust is a statutory trust created under the Delaware Statutory Trust Act and operating under a trust agreement among us, Wachovia Bank, National Association (formerly known as First Union National Bank), as the property trustee, Wachovia Trust Company, National Association (formerly known as First Union Trust Company, National Association), as Delaware trustee and one or more of our employees, as administrative trustee. In this prospectus, we refer to each of these agreements, as amended and restated, as a "trust agreement." Each Trust exists only to issue and sell its preferred trust securities and common trust securities, to acquire and hold our trust debt securities as trust assets and to engage in activities incidental to the foregoing. We will own all of each Trust's outstanding common trust securities. These common trust securities will represent at least 3% of the total capital of each Trust. Payments will be made on the common trust securities of a Trust pro rata with the preferred trust securities of that Trust, except that the right to payment on the common trust securities will be subordinated to the rights of the preferred trust securities if there is a default under the applicable trust agreement resulting from an event of default under the related trust debt indenture.

Each Trust's business and affairs will be conducted by its trustees and us, as depositor, as set forth in its trust agreement. The office of the Delaware trustee in the State of Delaware is One Rodney Square, 920 King Street, Suite 102, Wilmington, Delaware 19801. Each Trust's offices are located at 80 Park Plaza, Newark, NJ 07102 and its telephone number is (973) 430-7000.

RISK FACTORS

The following factors should be considered when reviewing our business and are relied upon by us in issuing any forward-looking statements. These factors could affect actual results and cause our results to differ materially from those expressed in any forward-looking statements made by, or on behalf of us. Some or all of these factors may apply to us and our subsidiaries.

Because A Portion Of Our Business Is Conducted Outside The United States, Adverse International Developments Could Negatively Impact Our Business

A component of our business strategy has been the development, acquisition and operation of projects outside the United States. The economic and political conditions in certain countries where Energy Holdings' subsidiary, PSEG Global Inc. ("Global"), has interests, or in which Global is or could be exploring development or acquisition opportunities, present risks that may be different than those found in the United States including:

- delays in permitting and licensing;
- construction delays and interruption of business;
- risks of war;
- expropriation;
- nationalization;

- renegotiation or nullification of existing contracts; and
- changes in law or tax policy.

Changes in the legal environment in foreign countries in which Global may develop or acquire projects could make it more difficult to obtain non-recourse project refinancing on suitable terms and could impair Global's ability to enforce its rights under agreements relating to such projects.

Operations in foreign countries also present risks associated with currency exchange and convertibility, inflation and repatriation of earnings. In some countries in which Global may develop or acquire projects in the future, economic and monetary conditions and other factors could affect Global's ability to convert its cash distributions to United States Dollars or other freely convertible currencies, or to move funds offshore from these countries. Furthermore, the central bank of any of these countries may have the authority to suspend, restrict or otherwise impose conditions on foreign exchange transactions or to approve distributions to foreign investors. Although Global generally seeks to structure power purchase contracts and other project revenue agreements to provide for payments to be made in, or indexed to, United States Dollars or a currency freely convertible into United States Dollars, its ability to do so in all cases may be limited.

Credit, Commodity And Financial Market Risks Could Negatively Impact Our Business

The revenues generated by the operation of our generating stations are subject to market risks that are beyond our control. Our generation output will either be used to satisfy our wholesale contracts or be sold into the competitive power markets or under other bilateral contracts. Participants in the competitive power markets are not guaranteed any specified rate of return on their capital investments through recovery of mandated rates payable by purchasers of electricity.

A majority of our revenue is generated by one-year contracts with various direct bidders of the New Jersey basic generation service ("BGS") Auction which expire on July 31, 2003, and from bilateral contracts for the sale of electricity with third-party load serving entities and power marketers. Our generation revenues and results of operations will be dependent upon prevailing market prices for energy, capacity and ancillary services in the markets we serve.

The following factors are among those that will influence the market prices for energy, capacity and ancillary services:

- the extent of additional supplies of capacity, energy and ancillary services from current competitors or new market entrants, including the development of new generation facilities that may be able to produce electricity less expensively;

- changes in the rules set by regulatory authorities with respect to the manner in which electricity sales will be priced;
- transmission congestion and access in PJM and/or other competitive markets;
- the operation of nuclear generation plants in PJM and other competitive markets beyond their presently expected dates of

decommissioning;

- prevailing market prices for enriched uranium, fuel oil, coal and natural gas and associated transportation costs;

- fluctuating weather conditions;

- reduced growth rate in electricity usage as a result of factors such as national and regional economic conditions and the implementation of conservation programs; and

- changes in regulations applicable to PJM and other Independent System Operators ("ISO").

As a result of the BGS auction, Power entered into contracts with the direct suppliers of the New Jersey electric utilities, including PSE&G, commencing August 1, 2002. These bilateral contracts are subject to credit risk. This credit risk relates to the ability of counterparties to meet their payment obligations for the power delivered under each BGS contract. Any failure to collect these payments under these BGS contracts with counterparties could have a material impact on our results of operations, cash flows and financial position.

Energy Obligations, Available Supply And Trading Risks Could Negatively Impact Our Business

Our energy trading and marketing activities frequently involve the establishment of energy trading positions in the wholesale energy markets on long-term and short-term bases. To the extent that we have forward purchase contracts to provide or purchase energy in excess of demand, a downturn in the markets is likely to result in a loss from a decline in the value of our long positions as we attempt to sell energy in a falling market. Conversely, to the extent that we enter into forward sales contracts to deliver energy we do not own, or take short positions in the energy markets, an upturn in the energy markets is likely to expose us to losses as we attempt to cover our short positions by acquiring energy in a rising market.

If the strategy we utilize to hedge our exposures to these various risks is not effective, we could incur significant losses. Our substantial energy trading positions can also be adversely affected by the level of volatility in the energy markets that, in turn, depends on various factors, including weather in various geographical areas and short-term supply and demand imbalances, which cannot be predicted with any certainty.

Counterparty Credit Risks Or A Deterioration Of Power's Credit Quality May Have An Adverse Impact On Our Business

We are exposed to the risk that counterparties will not perform their obligations. Although we have devoted significant resources to develop our risk management policies and procedures as well as counterparty credit requirements, and will continue to do so in the future, we can give no assurance that losses from our energy trading activities will not have a material adverse effect on our business, prospects, results of operations, financial condition or net cash flows.

In connection with its energy trading activities, Power must meet credit quality standards required by counterparties. Standard industry contracts generally require trading counterparties to maintain investment grade ratings. These same contracts provide reciprocal benefits to Power. If Power loses its investment grade credit rating, its subsidiary, PSEG Energy Resources & Trade LLC ("ER&T"), would have to provide collateral in the form of letters of credit or cash, which would significantly impact the energy trading business. This would increase our costs of doing business and limit our ability to successfully conduct our energy trading operations.

Substantial Change In The Electric Energy Industry Could Negatively Impact Our Business

The electric energy industry in the State of New Jersey, across the country and around the world is undergoing major transformations. As a result of deregulation and the unbundling of energy supplies and services, the electric energy markets are now open to competition from other suppliers in most markets. Increased competition from these suppliers could have a negative impact on our wholesale and retail sales. Among the factors that are common to the electric industry that affect our business are:

- ability to obtain adequate and timely rate relief, cost recovery, including unsecuritized stranded costs, and other necessary regulatory approvals;
- deregulation, the unbundling of energy supplies and services and the establishment of a competitive energy marketplace for products and services;
- energy sales retention and growth;
- revenue stability and growth;
- nuclear operations and decommissioning;
- increased capital investments attributable to environmental regulations;
- managing energy trading operations;
- ability to complete development or acquisition of current and future investments;
- managing electric generation and distribution operations in locations outside of traditional utility service territory;
- exposure to market price fluctuations and volatility;
- regulatory restrictions on affiliate transactions; and
- debt and equity market concerns.

Generation Operating Performance May Fall Below Projected Levels

Operation below expected capacity levels may result in lost revenues, increased expenses and penalties. Individual facilities may be unable to meet operating and financial obligations resulting in reduced cash flow.

The risks associated with operating power generation facilities, each of which could result in performance below expected capacity levels, include:

- breakdown or failure of equipment or processes;
- disruptions in the transmission of electricity;

- labor disputes;
- fuel supply interruptions;
- limitations which may be imposed by environmental or other regulatory requirements;
- permit limitations; and
- operator error or catastrophic events such as fires, earthquakes, explosions, floods, acts of terrorism or other similar occurrences.

Our Ability to Service Our Debt Could Be Limited

We are a holding company with no material assets other than the stock of our subsidiaries and project affiliates. Accordingly, all of our operations are conducted by our subsidiaries and project affiliates which are separate and distinct legal entities that have no obligation, contingent or otherwise, to pay any amounts when due on our debt or to make any funds available to us to pay such amounts. As a result, our debt will effectively be subordinated to all existing and future debt, trade creditors, and other liabilities of our subsidiaries and project affiliates and our rights and hence the rights of our creditors to participate in any distribution of assets of any subsidiary or project affiliate upon its liquidation or reorganization or otherwise would be subject to the prior claims of that subsidiary's or project affiliate's creditors, except to the extent that our claims as a creditor of such subsidiary or project affiliate may be recognized.

We depend on our subsidiaries' and project affiliates' cash flow and our access to capital in order to service our indebtedness. The project-related debt agreements of subsidiaries and project affiliates generally restrict their ability to pay dividends, make cash distributions or otherwise transfer funds to us. These restrictions may include achieving and maintaining financial performance or debt coverage ratios, absence of events of default, or priority in payment of other current or prospective obligations.

Our subsidiaries have financed some investments using non-recourse project level financing. Each non-recourse project financing is structured to be repaid out of cash flows provided by the investment. In the

event of a default under a financing agreement which is not cured, the lenders would generally have rights to the related assets. In the event of foreclosure after a default, our subsidiary may lose its equity in the asset or may not be entitled to any cash that the asset may generate. Although a default under a project financing agreement will not cause a default with respect to our debt and that of our subsidiaries, it may materially affect our ability to service our outstanding indebtedness.

We can give no assurances that our current and future capital structure, operating performance or financial condition will permit us to access the capital markets or to obtain other financing at the times, in the amounts and on the terms necessary or advisable for us to successfully carry out our business strategy or to service our indebtedness.

If Our Operating Performance Falls Below Projected Levels, We May Not Be Able to Service Our Debt

The risks associated with operating power generation facilities include the breakdown or failure of equipment or processes, labor disputes and fuel supply interruption, each of which could result in performance below expected capacity levels. Operation below expected capacity levels may result in lost revenues, increased expenses, higher maintenance costs and penalties, in which case there may not be sufficient cash available to service project debt. In addition, many of Global's generation projects rely on a single fuel supplier and a single customer for the purchase of the facility's output under a long term contract. While Global generally has liquidated damage provisions in its contracts, the default by a supplier under a fuel contract or a customer under a power purchase contract could adversely affect the facility's cash generation and ability to service project debt.

Countries in which Global owns and operates electric and gas distribution facilities may impose financial penalties if reliability performance standards are not met. In addition, inefficient operation of the facilities may cause lost revenue and higher maintenance expenses, in which case there may not be sufficient cash available to service project debt.

Our Ability To Control Cash Flow From Our Minority Investments Is Limited

Our ability to control investments in which we own a minority interest is limited. Assuming a minority ownership role presents additional risks, such as not having a controlling interest over operations and material financial and operating matters or the ability to operate the assets more efficiently. As such, neither we nor Global are able to unilaterally cause dividends or distributions to be made to us or Global from these operations.

Minority investments may involve risks not otherwise present for investments made solely by us and our subsidiaries, including the possibility that a partner, majority investor or co-venturer might become bankrupt, may have different interests or goals, and may take action contrary to our instructions, requests, policies or business objectives. Also, if no party has full control, there could be an impasse on decisions. In addition, certain investments of Energy Holdings' subsidiary, PSEG Resources LLC ("Resources"), are managed by unaffiliated entities which limits Resources' ability to control the activities or performance of such investments and managers.

Failure to Obtain Adequate and Timely Rate Relief Could Negatively Impact Our Business

As a public utility, PSE&G's rates are regulated by the New Jersey Board of Public Utilities ("BPU") and the Federal Energy Regulatory Commission ("FERC"). These rates are designed to recover its operating expenses and allow it to earn a fair return on its rate base, which primarily consists of its property, plant and equipment less various adjustments. These rates include its electric and gas tariff rates that are subject to regulation by the BPU as well as its transmission rates that are subject to regulation by the FERC. PSE&G's base rates are set by the BPU for electric distribution and gas distribution and are effective until the time a new rate case is brought to the BPU. These base rate cases generally take place every few years. Limited categories of costs are recovered through adjustment charges that are periodically reset to reflect actual costs. If these costs exceed the amount included in PSE&G's adjustment charges, there will be a negative impact on cash flows.

If PSE&G's operating expenses, other than costs recovered through adjustment charges, exceed the amount included in its base rates and in its FERC jurisdictional rates, there will be a negative impact on our earnings or operating cash flows.

Global's electric and gas distribution facilities are rate-regulated enterprises. Governmental authorities establish rates charged to customers. While these rates are designed to cover all operating costs and provide a return, considerable fiscal and cash uncertainties in certain countries due to economic, political and social crisis could have an adverse impact.

We can give no assurances that rates will, in the future, be sufficient to cover Global's costs and provide a return on its investment. In addition, future rates may not be adequate to provide cash flow to pay principal and interest on the debt of Global's subsidiaries' and affiliates or to enable its subsidiaries and affiliates to comply with the terms of debt agreements.

We May Not Have Access To Sufficient Capital In The Amounts And At The Times Needed

Capital for our projects and investments has been provided by internally-generated cash flow and borrowings by us and our subsidiaries. We require continued access to debt capital from outside sources in order to efficiently fund our capital needs and assure the success of our future projects and acquisitions. Our ability to arrange financing on a non-recourse basis and the costs of capital depend on numerous factors including, among other things, general economic and market conditions, the availability of credit from banks and other financial institutions, investor confidence, the success of current projects and the quality of new projects.

We can give no assurances that our current and future capital structure or financial condition will permit access to bank and debt capital markets. The availability of capital is not assured since it is dependent upon our performance and that of our other subsidiaries. As a result, there is no assurance that we or our subsidiaries will be successful in obtaining financing for our projects and acquisitions or funding the equity commitments required for such projects and acquisitions in the future.

We And Our Subsidiaries Are Subject To Substantial Competition From Well Capitalized Participants In The Worldwide Energy Markets

We and our subsidiaries are subject to substantial competition in the United States and in international markets from:

- merchant generators;
- domestic and multi-national utility generators;
- fuel supply companies;
- engineering companies;
- equipment manufacturers;
- and affiliates of other industrial companies.

Restructuring of worldwide energy markets, including the privatization of government-owned utilities and the sale of utility-owned assets, is creating opportunities for, and substantial competition from, well-capitalized entities which may adversely affect our ability to make investments on favorable terms and achieve our growth objectives. Increased competition could contribute to a reduction in prices offered for power and could result in lower returns which may affect our ability to service our outstanding indebtedness, including short-term debt.

Deregulation may continue to accelerate the current trend toward consolidation among domestic utilities and could also result in the further splitting of vertically-integrated utilities into separate generation, transmission and distribution businesses. As a result, additional competitors could become active in the merchant generation business. Resources faces competition from numerous well-capitalized investment and finance company affiliates of banks, utilities and industrial companies.

Power Transmission Facilities May Impact Our Ability To Deliver Our Output To Customers

Our ability to sell and deliver our electric energy products and grow our business may be adversely impacted and our ability to generate revenues may be limited if:

- transmission is disrupted,
- transmission capacity is inadequate, or
- a region's power transmission infrastructure is inadequate.

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Regulatory Issues Significantly Impact Our Operations

Federal, state and local authorities impose substantial regulation and permitting requirements on the electric power generation business. We are required to comply with numerous laws and regulations and to obtain numerous governmental permits in order to operate our generation stations.

We believe that we have obtained all material energy-related federal, state and local approvals including those required by the Nuclear Regulatory Commission (NRC), currently required to operate our generation stations. Although not currently required, additional regulatory approvals may be required in the future due to a change in laws and regulations or for other reasons. We cannot assure that we will be able to obtain any required regulatory approval in the future, or that we will be able to obtain any necessary extension in receiving any required regulatory approvals. Any failure to obtain or comply with any required regulatory approvals, could materially adversely affect our ability to operate our generation stations or sell electricity to third parties.

We are subject to pervasive regulation by the NRC with respect to the operation of our nuclear generation stations. This regulation involves testing, evaluation and modification of all aspects of plant operation in light of NRC safety and environmental requirements. The NRC also requires continuous demonstrations that plant operations meet applicable requirements. The NRC has the ultimate authority to determine whether any nuclear generation unit may operate.

We can give no assurance that existing regulations will not be revised or reinterpreted, that new laws and regulations will not be adopted or become applicable to us or any of our generation stations or that future changes in laws and regulations will not have a detrimental effect on our business.

Environmental Regulation May Limit Our Operations

We are required to comply with numerous statutes, regulations and ordinances relating to the safety and health of employees and the public, the protection of the environment and land use. These statutes, regulations and ordinances are constantly changing. While we believe that we have obtained all material environmental-related approvals currently required to own and operate our facilities or that these approvals have been applied for and will be issued in a timely manner, we may incur significant additional costs because of compliance with these requirements. Failure to comply with environmental statutes, regulations and ordinances could have a material effect on us, including potential civil or criminal liability and the imposition of clean-up liens or fines and expenditures of funds to bring our facilities into compliance.

We can give no assurance that we will be able to:

- obtain all required environmental approvals that we do not yet have or that may be required in the future;
- obtain any necessary modifications to existing environmental approvals;
- maintain compliance with all applicable environmental laws, regulations and approvals; or
- recover any resulting costs through future sales.

Delay in obtaining or failure to obtain and maintain in full force and effect any environmental approvals, or delay or failure to satisfy any applicable environmental regulatory requirements, could prevent construction of new facilities, operation of our existing facilities or sale of energy from these facilities or could result in significant additional cost to us.

We Are Subject To More Stringent Environmental Regulation Than Many Of Our Competitors

Our facilities are subject to both federal and state pollution control requirements. Most of our generating facilities are located in the State of New Jersey. In particular, New Jersey's environmental programs are generally considered to be more stringent in comparison to similar programs in other states. As such, there may be instances where the facilities located in New Jersey are subject to more stringent and, therefore, more costly pollution control requirements than competitive facilities in other states.

Insurance Coverage May Not Be Sufficient

We have insurance for our facilities, including:

- all-risk property damage insurance;
- commercial general public liability insurance;

- boiler and machinery coverage;
- nuclear liability; and
- for our nuclear generating units, replacement power and business interruption insurance in amounts and with deductibles that we consider appropriate.

We can give no assurance that this insurance coverage will be available in the future on commercially reasonable terms or that the insurance proceeds received for any loss of or any damage to any of our facilities will be sufficient to permit us to continue to make payments on our debt. Additionally, some of our properties may not be insured in the event of an act of terrorism.

Acquisition, Construction And Development Activities May Not Be Successful

We may seek to acquire, develop and construct new energy projects, the completion of any of which is subject to substantial risk. This activity requires a significant lead time and requires us to expend significant sums for preliminary engineering, permitting, fuel supply, resource exploration, legal and other development expenses in preparation for competitive bids or before it can be established whether a project is economically feasible.

The construction, expansion or refurbishment of a generation, transmission or distribution facility may involve:

- equipment and material supply interruptions;
- labor disputes;
- unforeseen engineering environmental and geological problems; and
- unanticipated cost overruns.

The proceeds of any insurance, vendor warranties or performance guarantees may not be adequate to cover lost revenues, increased expenses or payments of liquidated damages. In addition, some power purchase contracts permit the customer to terminate the contract, retain security posted by the developer as liquidated damages or change the payments to be made to the subsidiary or the project affiliate in the event specified milestones, such as commercial operation of the project, are not met by specified dates. If project start-up is delayed and the customer exercises these rights, the project may be unable to fund principal and interest payments under its project financing agreements. We can give no assurance that we will obtain access to the substantial debt and equity capital required to develop and construct new generation projects or to refinance existing projects to supply anticipated future demand.

Changes In Technology May Make Our Power Generation Assets Less Competitive

A key element of our business plan is that generating power at central power plants produces electricity at relatively low cost. There are other technologies that produce electricity, most notably fuel cells, microturbines, windmills and photovoltaic (solar) cells. While these methods are not currently cost-effective, it is possible that advances in technology will reduce the cost of alternative methods of producing electricity to a level that is competitive with that of most central station electric production. If this were to happen, our market share could be eroded and the value of our power plants could be significantly impaired. Changes in technology could also alter the channels through which retail electric customers buy electricity, which could affect our financial results.

Recession, Acts Of War Or Terrorism Could Negatively Impact Our Business

The consequences of a prolonged recession and adverse market conditions may include the continued uncertainty of energy prices and the capital and commodity markets. We cannot predict the impact of any continued economic slowdown or fluctuating energy prices; however, such impact could have a material adverse effect on our financial condition, results of operations and net cash flows.

Like other operators of major industrial facilities, our generation plants, fuel storage facilities and transmission and distribution facilities may be targets of terrorist activities that could result in disruption of our ability to produce or distribute some portion of our energy products. Any such disruption could result in a significant decrease in revenues and/or significant additional costs to repair, which could have a material adverse impact on our financial condition, results of operation and net cash flows.

FORWARD-LOOKING STATEMENTS

This prospectus includes "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical facts, included in this prospectus or in the documents or information incorporated by reference or deemed to be incorporated by reference in this prospectus that address activities, events or developments that we expect or anticipate will or may occur in the future, including such matters as our projections, future capital expenditures, business strategy, competitive strengths, goals, expansion, market and industry developments and the growth of our businesses and operations, are forward-looking statements. These statements are based on assumptions and analyses made by us in light of our experience and our perception of historical trends, current conditions and expected future developments as well as other factors we believe are appropriate under the circumstances. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those anticipated. These statements are based on management's beliefs as well as assumptions made by and information currently available to management. When used herein, the words "will," "anticipate," "intend," "estimate," "believe," "expect," "plan," "hypothetical," "potential," and variations of such words and similar expressions are intended to identify forward-looking statements. The following review of factors should not be construed as exhaustive or as any admission regarding the adequacy of our disclosures prior to the effective date of the Private Securities Litigation Reform Act of 1995. These risks and uncertainties include:

- the significant considerations and risks discussed in any incorporated document or prospectus supplement;
- general and local economic, market or business conditions;
- industrial, commercial and residential growth in the markets we serve;
- since a portion of our business is conducted outside the United States, adverse international developments;
- demand (or lack thereof) for electricity, capacity and ancillary services in the markets served by our generation units;
- increasing competition from other companies;
- the acquisition and development opportunities (or lack thereof) that may be presented to and pursued by us;
- terrorist threats and activities, particularly with respect to our generation facilities, economic uncertainty caused by recent terrorist attacks on the United States and potential adverse reactions to United States anti-terrorism activities;
- nuclear decommissioning and the availability of storage facilities for spent nuclear fuel;
- changes in laws or regulations that are applicable to us;
- environmental constraints on construction and operation;

- the rapidly changing market for energy products;
- licensing approval for our nuclear and other operating stations;
- the ability to economically and safely operate our generating facilities in accordance with regulatory requirements;
- the ability to obtain adequate and timely rate relief in our regulated businesses;
- the ability to maintain insurance for our operations and facilities at reasonable rates;
- access to capital;
- credit, commodity and financial market risks; and
- other factors, such as weather conditions, many of which are beyond our control.

Consequently, all of the forward-looking statements made in this prospectus are qualified by these cautionary statements and we cannot assure you that the results or developments anticipated by us will be realized or, even if realized, will have the expected consequences to or effects on us or our business prospects, financial condition or results of operations. You should not place undue reliance on these forward-looking statements in making your investment decision. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to these forward-looking statements to reflect events or circumstances that occur or arise or are anticipated to occur or arise after the date hereof. In making an investment decision regarding the securities, we are not making, and you should not infer, any representation about the likely existence of any particular future set of facts or circumstances. The forward-looking statements contained in this prospectus, any prospectus supplement and the documents incorporated by reference or deemed to be incorporated by reference into this prospectus and any related prospectus supplement are intended to qualify for the safe harbor provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended.

USE OF PROCEEDS

Unless otherwise indicated in the applicable prospectus supplement, we will use the net proceeds from the sale of the securities for general corporate purposes, including repayment of outstanding debt. Each Trust will use all of the proceeds received from the sale of its preferred trust securities and common trust securities to purchase our trust debt securities.

ACCOUNTING TREATMENT RELATING TO PREFERRED TRUST SECURITIES

The financial statements of each Trust will be consolidated with our financial statements, with the respective preferred trust securities shown on our consolidated financial statements as our guaranteed preferred beneficial interest in trust debt securities. Our financial statements will include a footnote that discloses, among other things, that the assets of a Trust consist of our trust debt securities and will specify the designation, principal amount, interest rate or formula and maturity date of the trust debt securities.

DESCRIPTION OF THE SENIOR AND SUBORDINATED DEBT SECURITIES

We may issue from time to time one or more series of the senior debt securities under our Senior Indenture dated as of November 1, 1998 between us and Wachovia Bank, National Association (formerly known as First Union National Bank), as Senior Trustee, or one or more series of the subordinated debt securities under our Subordinated Indenture to be entered into between us and Wachovia Bank, National Association, as Subordinated Trustee. The term "Trustee" refers to either the Senior Trustee or the Subordinated Trustee, as appropriate. We will provide information about these debt securities in a prospectus supplement.

The Senior Indenture and the form of Subordinated Indenture (sometimes together referred as the "Indentures" and, individually, as an "Indenture") are filed or incorporated by reference as exhibits to the registration statement of which this prospectus is a part. The Indentures are subject to and governed by the Trust Indenture Act of 1939. We have summarized the material terms and provisions of the Indentures. Because this section is a summary, it does not describe every aspect of the debt securities and the Indentures. We urge you to read the Indenture that governs your debt securities for provisions that may be important to you.

Provisions Applicable to Both the Senior and Subordinated Indentures

General

The debt securities will be our unsecured obligations. The senior debt securities will rank equally with all other of our unsecured and unsubordinated indebtedness. The subordinated debt securities will be subordinated in right of payment to the prior payment in full of our senior indebtedness as described below under " Subordinated Indenture Provisions." In this section, unless the context requires, the words "we," "our," "ours" and "us" refer to Public Service Enterprise Group Incorporated and not its consolidated subsidiaries.

Because we are a holding company and conduct all of our operations through our subsidiaries, holders of our debt securities will generally have a junior position to claims of creditors of those subsidiaries, including trade creditors, debt holders, secured creditors, taxing authorities, guarantee holders and any preferred stockholders other than, in each case, where we are the creditor. As of September 30, 2002, PSE&G had 795,234 shares of its preferred stock outstanding with an aggregate par value of approximately $80 million. Our subsidiaries have ongoing corporate debt programs used to finance their business activities. As of September 30, 2002, our subsidiaries had approximately $13.0 billion of debt outstanding.

Each Indenture provides that any debt securities proposed to be sold under this prospectus and the accompanying prospectus supplement may be issued in an unlimited amount under that Indenture in one or more series, in each case as authorized by us from time to time.

You should read the relevant prospectus supplement for a description of the material terms of any debt securities being offered, including:

- o the title of the debt securities and whether the debt securities will be senior debt securities or subordinated debt securities;
- o the aggregate principal amount of the debt securities and any limit on the aggregate principal amount of the debt securities of that series;

o if less than the principal amount of the debt securities are payable upon acceleration of the maturity of the debt securities, the portion that will be payable or how this portion will be determined;

o the date or dates, or how the date or dates will be determined or extended, on which the principal of the debt securities will be payable;

o the rate or rates of interest, which may be fixed or variable, that the debt securities will bear, if any, or how the rate or rates will be determined;

o the terms of any remarketing of the debt securities;

o the date or dates from which interest, if any, on the debt securities will accrue or how the date or dates will be determined;

o the interest payment dates, if any, and the record dates for any interest payments or how the date or dates will be determined;

o the basis upon which interest will be calculated if other than that of a 360-day year of twelve 30-day months;

o the right, if any, to extend interest payment periods and the duration of any extension;

o any optional redemption provisions;

o any sinking fund or other provisions that would obligate us to repurchase or otherwise redeem the debt securities;

o whether the debt securities will be issued as registered securities, bearer securities or both and any applicable restrictions;

o whether the debt securities will be issuable in temporary or permanent global form and any applicable restrictions or limitations;

o the place or places where the principal of and any premium and interest on the debt securities will be payable and to whom and how those payments will be made;

o whether the debt securities are convertible or exchangeable into any other securities and, if so, the applicable terms and conditions;

o the denominations in which the debt securities will be issuable, if other than $1,000 or any integral multiple thereof in the case of registered securities and $5,000 in the case of bearer securities;

o the index, if any, with reference to which the amount of principal of or any premium or interest on the debt securities will be determined;

o if other than the Trustee, the identity of each security registrar and/or paying agent;

o the applicability of the provisions of the applicable Indenture described below under "-- Satisfaction and Discharge, Defeasance and Covenant Defeasance" and any provisions in modification of, in addition to or in lieu of any of these provisions;

- whether and under what circumstances we will pay additional amounts in respect of any tax, assessment or governmental charge and, if so, whether we will have the option to redeem the debt securities rather than pay the additional amounts (and the terms of this option);

- any deletions, additions or changes in the events of default in the applicable Indenture and any change in the right of the Trustee or the holders to declare the principal amount of the debt securities due and payable;

- any deletions, additions or changes in the covenants in the applicable Indenture;

- the applicability of or any change in the subordination provisions of the Indenture for a series of debt securities;

- any provisions granting special rights to holders of the debt securities upon the occurrence of specified events; and

- any other material terms of the debt securities.

If applicable, the prospectus supplement will also set forth information concerning any other securities offered thereby and a discussion of federal income tax considerations relevant to the debt securities being offered.

For purposes of this prospectus, any reference to the payment of principal of or premium or interest, if any, on the debt securities will include the payment of any additional amounts required by the terms of the debt securities.

Debt securities may provide for less than the entire principal amount to be payable upon acceleration of the maturity date ("original issue discount securities"). Federal income tax and other matters concerning any original issue discount securities will be discussed in the applicable prospectus supplement.

Neither Indenture limits the amount of debt securities that may be issued in distinct series from time to time. Debt securities issued under an Indenture are referred to, when a single Trustee is acting as trustee for all debt securities issued under an Indenture, as the "indenture securities." Each Indenture provides that there may be more than one Trustee thereunder, each with respect to one or more different series of indenture securities. See "--Resignation of Trustee" below. At a time when two or more Trustees are acting under either Indenture, each with respect to only certain series, the term indenture securities will mean the one or more series with respect to which each respective Trustee is acting. In the event that there is more than one Trustee under either Indenture, the powers and trust obligations of each Trustee as described herein will extend only to the one or more series of indenture securities for which it is Trustee. If two or more Trustees are acting under either Indenture, then the indenture securities for which each Trustee is acting would in effect be treated as if issued under separate indentures.

The general provisions of the Indentures do not contain any provisions that would limit our ability to incur indebtedness or that would afford holders of debt securities protection in the event of a highly leveraged or similar transaction involving us. Please refer to the prospectus supplement for information with respect to any deletions from, modifications of or additions to the events of default or our covenants that are described below, including any addition of a covenant or other provision providing event risk or similar protection.

We have the ability to issue indenture securities with terms different from those of indenture securities previously issued and, without the consent of the holders thereof, to reopen a previous series of indenture securities and issue additional indenture securities of that series, unless the reopening was restricted when that series was created.

Denominations, Registration and Transfer

Debt securities of a series may be issuable solely as registered securities, solely as bearer securities or as both registered securities and bearer securities. The Indentures also provide that debt securities of a series may be issuable in global form. See "-- Book-Entry Debt Securities." Unless otherwise provided in the prospectus

supplement, debt securities denominated in U.S. dollars (other than global securities, which may be of any denomination) are issuable in denominations of $1,000 or any integral multiples of $1,000 (in the case of registered securities) and in the denomination of $5,000 (in the case of bearer securities). Unless otherwise indicated in the prospectus supplement, bearer securities will have interest coupons attached.

Registered securities will be exchangeable for other registered securities of the same series. If provided in the prospectus supplement, bearer securities (with all unmatured coupons, except as provided below, and all matured coupons which are in default) of any series may be similarly exchanged for registered securities of the same series of any authorized denominations and of a like aggregate principal amount and tenor. If so provided, bearer securities surrendered in exchange for registered securities between a regular record date or a special record date and the relevant date for payment of interest will be surrendered without the coupon relating to that date for payment of interest, and interest will not be payable in respect of the registered security issued in exchange for the bearer security, but will be payable only to the holder of the coupon when due in accordance with the terms of the applicable Indenture. Unless otherwise specified in the prospectus supplement, bearer securities will not be issued in exchange for registered securities.

Registered securities of a series may be presented for registration of transfer and debt securities of a series may be presented for exchange

- at each office or agency required to be maintained by us for payment of that series as described in "-- Payment and Paying Agents" below, and

- at each other office or agency that we may designate from time to time for those purposes.

No service charge will be made for any transfer or exchange of debt securities, but we may require payment of any tax or other governmental charge payable in connection with the transfer or exchange.

We will not be required to

- issue, register the transfer of or exchange debt securities during a period beginning at the opening of business 15 days before any selection of debt securities of that series to be redeemed and ending at the close of business on

  - if debt securities of the series are issuable only as registered securities, the day of mailing of the relevant notice of redemption and

  - if debt securities of the series are issuable as bearer securities, the day of the first publication of the relevant notice of redemption, or, if debt securities of the series are also issuable as registered securities and there is no publication, the day of mailing of the relevant notice of redemption;

- register the transfer of or exchange any registered security, or portion thereof, called for redemption, except the unredeemed portion of any registered security being redeemed in part;

- exchange any bearer security called for redemption, except to exchange the bearer security for a registered security of that series and like tenor that is simultaneously surrendered for redemption; or

- issue, register the transfer of or exchange any debt security which has been surrendered for repayment at the option of the holder, except the portion, if any, of that debt security not to be so repaid.

Payment and Paying Agents

Unless otherwise provided in the prospectus supplement, premium, interest and additional amounts, if any, on registered securities will be payable at any office or agency to be maintained by us in Morristown, New Jersey and The City of New York, except that at our option interest may be paid

- by check mailed to the address of the person entitled thereto appearing in the security register or

- by wire transfer to an account maintained by the person entitled thereto as specified in the security register.

Unless otherwise provided in the prospectus supplement, payment of any installment of interest due on any interest payment date for registered securities will be made to the person in whose name the registered security is registered at the close of business on the regular record date for that interest.

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If debt securities of a series are issuable solely as bearer securities or as both registered securities and bearer securities, unless otherwise provided in the prospectus supplement, we will be required to maintain an office or agency

- outside the United States where, subject to any applicable laws and regulations, the principal of and premium, and interest, if any, on the series will be payable and

- in The City of New York for payments with respect to any registered securities of that series (and for payments with respect to bearer securities of that series in the limited circumstances described below, but not otherwise);

provided that, if required in connection with any listing of debt securities on the Luxembourg Stock Exchange or any other stock exchange located outside the United States, we will maintain an office or agency for those debt securities in any city located outside the United States required by the applicable stock exchange. The initial locations of those offices and agencies will be specified in the prospectus supplement. Unless otherwise provided in the prospectus supplement, principal of and premium, if any and interest, if any, on bearer securities may be paid by wire transfer to an account maintained by the person entitled thereto with a bank located outside the United States. Unless otherwise provided in the prospectus supplement, payment of installments of interest on any bearer securities on or before maturity will be made only against surrender of coupons for those interest installments as they mature. Unless otherwise provided in the prospectus supplement, no payment with respect to any bearer security will be made at any office or agency of ours in the United States or by check mailed to any address in the United States or by transfer to an account maintained with a bank located in the United States. However, payments of principal of and premium, if any and interest, if any, on bearer securities payable in U.S. dollars will be made at the office of our paying agent in The City of New York if payment of the full amount thereof in U.S. dollars at all offices or agencies outside the United States is illegal or effectively precluded by exchange controls or other similar restrictions.

We may from time to time designate additional offices or agencies, approve a change in the location of any office or agency and, except as provided above, rescind the designation of any office or agency.

Events of Default

The following will constitute events of default under each Indenture with respect to any series of debt securities, unless we state otherwise in the applicable prospectus supplement:

- we do not pay interest on a debt security of that series within 30 days of its due date;

- we do not pay principal of, or any premium on, a debt security of the series on its due date;

- we do not deposit any sinking fund payment when due by the terms of any debt security of that series;

- we remain in breach of a covenant in respect of the debt securities of the series for 60 days after we receive a written notice of default stating we are in breach. The notice must be sent by either the Trustee or holders of at least 25% of the principal amount of debt securities of the series;

- we file for bankruptcy or a court appoints a custodian or orders our liquidation under any bankruptcy law or certain other events in bankruptcy, insolvency or reorganization occur; and

- any other event of default provided with respect to debt securities of that series occurs.

We are required to file with the Trustee, annually, an officer's certificate as to our compliance with all conditions and covenants under the applicable Indenture. Each Indenture provides that the Trustee may withhold notice to the holders of debt securities of a series of any default (except payment defaults on the debt securities of that series) if it considers it in the interest of the holders of debt securities of such series to do so.

If an event of default with respect to debt securities of a series has occurred and is continuing, the Trustee or the holders of not less than 25% in principal amount of outstanding debt securities of that series may declare the applicable principal amount of all of the debt securities of that series to be due and payable immediately.

Subject to the provisions of the applicable Indenture relating to the duties of the Trustee, in case an event of default with respect to debt securities of a series has occurred and is continuing, the Trustee is under no obligation to exercise any of its rights or powers under the Indenture at the request, order or direction of the

holders of debt securities of that series, unless the holders have offered the Trustee reasonable indemnity against the expenses and liabilities which might be incurred by it in compliance with that request. Subject to such provisions for the indemnification of the Trustee, the holders of a majority in principal amount of the outstanding debt securities of a series will have the right to direct the time, method and place of conducting any proceeding for any remedy available to the Trustee, or exercising any trust or power conferred on the Trustee with respect to the debt securities of that series.

The holders of a majority in principal amount of the outstanding debt securities of a series may, on behalf of the holders of all debt securities of that series and any related coupons, waive any past default with respect to that series and its consequences, except a default

- in the payment of the principal of, or premium, or interest, if any, on any debt security of that series or any related coupons or
- relating to a covenant or provision that cannot be modified or amended without the consent of the holder of each outstanding debt security of that series affected by the modification or amendment.

Merger or Consolidation

Each Indenture provides that we may not consolidate with or merge with or into any other corporation or convey or transfer our properties and assets as an entirety or substantially as an entirety to any person, unless either we are the continuing corporation or such corporation or person assumes by supplemental indenture all of our obligations under such Indenture and the securities issued thereunder and immediately after the transaction no default shall exist.

Modification or Waiver

Modification and amendment of each Indenture may be made by us and the Trustee thereunder with the consent of the holders of a majority in principal amount of all outstanding indenture securities issued thereunder that are affected by the modification or amendment. The consent of the holder of each outstanding indenture security affected is, however, required to:

- change the maturity of the principal of or any installment of principal of or interest on that indenture security;
- reduce the principal amount of, or the rate or amount of interest in respect of, or any premium payable upon the redemption of, that indenture security, or change the manner of calculation thereof;
- change our obligation, if any, to pay additional amounts in respect of that indenture security;
- reduce the portion of the principal of an original issue discount security or indexed security that would be due and payable upon a

declaration of acceleration of the maturity date thereof or provable in bankruptcy;

- adversely affect any right of repayment at the option of the holder of that indenture security;
- change the place or currency of payment of principal, premium or interest on that indenture security;
- impair the right to institute suit for the enforcement of any such payment on or after the maturity date, redemption date or repayment date;
- adversely affect any right to convert or exchange that indenture security;
- reduce the percentage in principal amount of that outstanding indenture securities required to amend or waive compliance with certain provisions of the applicable Indenture or to waive certain defaults;
- reduce the requirements for voting or quorum described below; or
- modify any of the foregoing requirements or any of the provisions relating to waiving past defaults or compliance with certain restrictive provisions, except to increase the percentage of holders required to effect any such waiver or to provide that certain other provisions of the Indenture cannot be modified or waived without the consent of the holders of each indenture security affected thereby.

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In addition, under the Subordinated Indenture, no modification or amendment thereof may, without the consent of the holder of each outstanding subordinated security affected thereby, modify any of the provisions of that Indenture relating to the subordination of the subordinated securities in a manner adverse to the holders and no such modification or amendment may adversely affect the rights of any holder of senior indebtedness described under the caption "--Subordinated Indenture Provisions" without the consent of that holder of senior indebtedness.

The holders of a majority in aggregate principal amount of outstanding indenture securities have the right to waive our compliance with certain covenants in the applicable Indenture.

Modification and amendment of each Indenture may be made by the Trustee and us, without the consent of any holder, for any of the following purposes:

- to evidence the succession of another person to us as obligor under such Indenture;
- to add to our covenants for the benefit of the holders of all or any series of indenture securities issued under the Indenture or to surrender any right or power conferred upon us by the Indenture;
- to add events of default for the benefit of the holders of all or any series of indenture securities;
- to add to or change any provisions of the Indenture to facilitate the issuance of, or to liberalize the terms of, bearer securities, or to

permit or facilitate the issuance of indenture securities in uncertificated form, provided that any such actions do not adversely affect the holders of the indenture securities or any related coupons;

- to change or eliminate any provisions of the Indenture, as long as that change or elimination will become effective only when there are no indenture securities outstanding entitled to the benefit of those provisions;

- to secure the indenture securities under the applicable Indenture pursuant to any requirements of the Indenture, or otherwise;

- to establish the form or terms of indenture securities of any series and any related coupons;

- to provide for the acceptance of appointment by a successor Trustee or facilitate the administration of the trusts under the Indenture by more than one Trustee;

- to cure any ambiguity, defect or inconsistency in the Indenture, provided that action does not adversely affect the interests of holders of indenture securities of a series issued thereunder or any related coupons in any material respect; or

- to supplement any of the provisions of the Indenture to the extent necessary to permit or facilitate defeasance and discharge of any series of indenture securities thereunder, provided that the action does not adversely affect the interests of the holders of any indenture securities and any related coupons in any material respect.

In determining whether the holders of the requisite principal amount of outstanding indenture securities have given any request, demand, authorization, direction, notice, consent or waiver under the applicable Indenture or whether a quorum is present at a meeting of holders of indenture securities thereunder,

- the principal amount of an original issue discount security that will be deemed to be outstanding will be the amount of the principal thereof that would be due and payable as of the date of such determination upon acceleration of the maturity thereof,

- the principal amount of an indexed security that may be counted in making such determination will be equal to the principal face amount of the indexed security at original issuance, unless otherwise provided with respect to the indexed security pursuant to the Indenture and

- indenture securities owned by us or any other obligor upon the indenture securities or any affiliate of ours or of any other obligor shall be disregarded.

Each Indenture contains provisions for convening meetings of the holders of indenture securities of a series if indenture securities of that series are issuable as bearer securities. A meeting may be called at any time by the Trustee, and also, upon request, by us or the holders of at least 10% in principal amount of the outstanding

indenture securities of that series, in any such case upon notice given as provided in the applicable Indenture. Except for any consent that must be given by the holder of each indenture security affected thereby, as described above, any resolution presented at a meeting at which a quorum is present may be adopted by the affirmative vote of the holders of a majority in principal amount of the outstanding indenture securities of that series; except that any resolution with respect to any action that may be made, given or taken by the holders of a specified percentage which is less than a majority in principal amount of the outstanding indenture securities of a series may be adopted at a meeting at which a quorum is present by the affirmative vote of the holders of that specified percentage in principal amount of the outstanding indenture securities of that series. Any resolution passed or decision taken at any meeting of holders of indenture securities of a series held in accordance with the applicable Indenture will be binding on all holders of indenture securities of that series and any related coupons. The quorum at any meeting called to adopt a resolution will be persons holding or representing a majority in principal amount of the outstanding indenture securities of a series; except that, if any action is to be taken at the meeting with respect to a consent or waiver which may be given by the holders of not less than a specified percentage in principal amount of the outstanding indenture securities of a series, the persons holding or representing that specified percentage in principal amount of the outstanding indenture securities of that series will constitute a quorum.

Satisfaction and Discharge, Full Defeasance and Covenant Defeasance

We may discharge certain of our obligations to holders of debt securities of a series that have not already been delivered to the Trustee for cancellation and that either have become due and payable or are due and payable within one year (or scheduled for redemption within one year) by irrevocably depositing with the applicable Trustee, in trust, funds in an amount sufficient to make interest, principal and any other payments on the debt securities on their various due dates.

Each Indenture provides that, if the series of the debt securities provides for it, we may elect either to defease and be discharged from any and all obligations with respect to the debt securities and any related coupons, with certain limited exceptions (this is called "full defeasance") or to be released from our obligations under any specified covenant with respect to those debt securities and any related coupons, and any omission to comply with those obligations shall not constitute a default or an event of default with respect to those debt securities and any related coupons (this is called "covenant defeasance").

In order to effect full defeasance or covenant defeasance, we must deposit for the benefit of all holders of the debt securities of the particular series a combination of cash and/or U.S. government securities or U.S. government agency notes or bonds that will generate enough cash to make interest, principal and other payments on the debt securities on their various due dates.

A trust may only be established if, among other things, we have delivered to the Trustee a legal opinion stating that the holders of the debt securities and any related coupons will not recognize income, gain or loss for United States federal income tax purposes as a result of the defeasance or covenant defeasance and will be subject to United States federal income tax on the same amounts, in the same manner and at the same times as would have been the case if the defeasance or covenant defeasance had not occurred, and the legal opinion, in the case of full defeasance must refer to and be based upon a ruling of the Internal Revenue Service or a change in applicable United States federal income tax law occurring after the date of the Indenture.

In the event we effect covenant defeasance with respect to any debt securities and any related coupons and those debt securities and coupons are declared due and payable because of the occurrence of certain events of default with respect to any covenant as to which there has been covenant defeasance, the amount of funds on deposit with the Trustee will be sufficient to pay amounts due on those debt securities and coupons at the time of their stated maturity date but may not be sufficient to pay amounts due on those debt securities and coupons at the time of the acceleration resulting from the event of default. In such case, we would remain liable to make payment of those amounts due at the time of acceleration.

If the Trustee or any paying agent is unable to apply any money in accordance with the applicable Indenture by reason of any order or judgment of any court or governmental authority enjoining, restraining or otherwise prohibiting such application, then our obligations under the Indenture and the debt securities and any related coupons will be revived and reinstated as though no deposit had occurred pursuant to the Indenture, until the Trustee or paying agent is permitted to apply all such money in accordance with such Indenture.

The prospectus supplement may further describe the provisions, if any, permitting full defeasance or covenant defeasance, including any modifications to the provisions described above, with respect to the debt securities of or within a particular series and any related coupons.

Book-Entry Debt Securities

Debt securities of a series may be issued, in whole or in part, in global form that will be deposited with, or on behalf of, a depositary identified in the prospectus supplement. Global securities may be issued in either registered or bearer form and in either temporary or permanent form (a "global security"). Unless otherwise provided in the prospectus supplement, debt securities that are represented by a global security will be issued in denominations of $1,000 and any integral multiple thereof, and will be issued in registered form only, without coupons. Payments of principal of (and premium, if any) and interest, if any, on debt securities represented by a global security will be made by us to the Trustee and then by the Trustee to the depositary.

We anticipate that any global securities will be deposited with, or on behalf of, The Depository Trust Company ("DTC"), New York, New York, that global securities will be registered in the name of DTC's nominee, and that the following provisions will apply to the depositary arrangements with respect to any global securities. Additional or differing terms of the depositary arrangements will be described in the prospectus supplement.

So long as DTC or its nominee is the registered owner of a global security, DTC or its nominee, as the case may be, will be considered the sole holder of the debt securities represented by such global security for all purposes under the applicable Indenture. Except as provided below, owners of beneficial interests in a global security will not be entitled to have debt securities represented by the global security registered in their names, will not receive or be entitled to receive physical delivery of debt securities in certificated form and will not be considered the owners or holders thereof under the applicable Indenture. The laws of some states require that certain purchasers of securities take physical delivery of such securities in certificated form; those laws may limit the transferability of beneficial interests in a Global Security.

If

- DTC is at any time unwilling, unable or ineligible to continue as depositary and a successor depositary is not appointed by us within 90 days following notice to us;

- we determine, in our sole discretion, not to have any debt securities represented by one or more global securities; or

- an event of default under the applicable Indenture has occurred and is continuing, then we will issue individual debt securities in certificated form in exchange for the relevant global securities.

In any such instance, an owner of a beneficial interest in a global security will be entitled to physical delivery of individual debt securities in certificated form of like tenor and rank, equal in principal amount to such beneficial interest and to have such debt securities in certificated form registered in its name. Unless otherwise provided in the prospectus supplement, debt securities so issued in certificated form will be issued in denominations of $1,000 or any integral multiple thereof and will be issued in registered form only, without coupons.

The following is based on information furnished by DTC and applies to the extent that it is the depositary, unless otherwise provided in the prospectus supplement:

Registered Owner. The debt securities will be issued as fully registered securities in the name of Cede & Co., which is DTC's partnership nominee. The Trustee will deposit the global securities with the depositary. The deposit with the depositary and its registration in the name of Cede & Co. will not change the nature of the actual purchaser's ownership interest in the debt securities.

DTC's Organization. DTC is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of that law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934.

DTC is owned by a number of its direct participants and the New York Stock Exchange, Inc., the American Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Direct participants include securities brokers and dealers, banks, trust companies, clearing corporations and some other organizations that

directly participate in DTC. Other entities may access DTC's system by clearing transactions through or maintaining a custodial relationship with direct participants. The rules applicable to DTC and its participants are on file with the SEC.

DTC's Activities. DTC holds securities that its participants deposit with it. DTC also facilitates the settlement among participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerized book-entry changes in participants' accounts. Doing so eliminates the need for physical movement of securities certificates.

Participant's Records. Except as otherwise provided in this prospectus or a prospectus supplement, purchases of debt securities must be made by or through a direct participant, which will receive a credit for the debt securities on the depositary's records. The purchaser's interest is in turn to be recorded on the participant's records. Actual purchasers will not receive written confirmation from the depositary of their purchase, but they generally receive confirmations, along with periodic statements of their holdings, from the participants through which they entered into the transaction.

Transfers of interests in the global securities will be made on the books of the participants on behalf of the actual purchasers. Certificates representing the interest in debt securities will not be issued unless the use of global securities is suspended.

The depositary has no knowledge of the actual purchasers of global securities. The depositary's records only reflect the identity of the direct participants, who are responsible for keeping account of their holdings on behalf of their customers.

Notices among the Depositary, Participants and Actual Purchasers. Notices and other communications by the depositary, its participants and the actual purchasers will be governed by arrangements among them, subject to any legal requirements in effect. Any redemption notices will be sent to DTC. If less than all of the securities within an issue are being redeemed, DTC's practice is to determine by lot the amount of the interest of each direct participant in such issue to be redeemed.

Voting Procedures. Neither DTC nor Cede & Co. will give consents for or vote the global securities. The depositary generally mails an omnibus proxy to us just after the applicable record date. That proxy assigns Cede & Co.'s voting rights to the direct participants to whose accounts the debt securities are credited at that time.

Payments. Principal and interest payments made by us will be delivered to the depositary. DTC's practice is to credit direct participants' accounts on the applicable payment date unless it has reason to believe that it will not receive payment on that date. Payments by participants to actual purchasers will be governed by standing instructions and customary practices, as is the case with securities held for customers in bearer form or registered in "street name." Those payments will be the responsibility of that participant and not the depositary, the applicable Trustee or us, subject to any legal requirements in effect at that time.

We are responsible for payment of principal, interest and premium, if any, to the Trustee who is responsible for paying it to the depositary. The depositary is responsible for disbursing those payments to direct participants. The participants are responsible for disbursing payments to the actual purchasers.

DTC may discontinue providing its services as securities depositary with respect to the debt securities at any time by giving reasonable notice to the applicable paying agent or us. Under such circumstances, in the event that a successor securities depositary is not appointed, debt security certificates are required to be printed and delivered.

We may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depositary). In that event, debt security certificates will be printed and delivered.

The information in this section concerning DTC and DTC's book-entry system has been obtained from sources (including DTC) that we believe to be reliable, but we take no responsibility for the accuracy thereof.

Unless stated otherwise in the prospectus supplement, the underwriters or agents with respect to a series of debt securities issued as global securities will be direct participants in DTC.

None of any underwriter or agent, the Trustees, any applicable paying agent or us will have any responsibility or liability for any aspect of the records relating to or payments made on account of beneficial interests in a global security, or for maintaining, supervising or reviewing any records relating to such beneficial interests.

Resignation of Trustee

The Trustee may resign or be removed with respect to one or more series of indenture securities and a successor Trustee may be appointed to act with respect to the series. In the event that two or more persons are acting as Trustee with respect to different series of indenture securities under one of the Indentures, each such Trustee shall be a Trustee of a trust thereunder separate and apart from the trust administered by any other Trustee, and any action described herein to be taken by the Trustee may then be taken by each Trustee with respect to, and only with respect to, the one or more series of indenture securities for which it is Trustee.

Subordinated Indenture Provisions

Upon any distribution of our assets upon any dissolution, winding up, liquidation or reorganization, the payment of the principal of and premium and interest, if any, on subordinated securities is to be subordinated to the extent provided in the Subordinated Indenture in right of payment to the prior payment in full of all Senior Indebtedness, but our obligation to make payment of the principal of and premium and interest, if any, on the subordinated securities will not otherwise be affected. In addition, no payment on account of principal or premium, sinking fund or interest, if any, may be made on the subordinated securities at any time unless full payment of all amounts due in respect of the principal and premium, sinking fund and interest on Senior Indebtedness has been made or duly provided for in money.

In the event that, notwithstanding the foregoing, any payment by us is received by the Subordinated Trustee or the holders of any of the subordinated securities before all Senior Indebtedness is paid in full, the payment or distribution shall be paid over to the holders of the Senior Indebtedness or on their behalf for application to the payment of all the Senior Indebtedness remaining unpaid until all the Senior Indebtedness has been paid in full, after giving effect to any concurrent payment or distribution to the holders of the Senior Indebtedness. Subject to the payment in full of all Senior Indebtedness upon this distribution, the holders of the subordinated securities will be subrogated to the rights of the holders of the Senior Indebtedness to the extent of payments made to the holders of the Senior Indebtedness out of the distributive share of the subordinated securities.

By reason of the subordination, in the event of a distribution of assets upon insolvency, certain of our general creditors may recover more, ratably, than holders of the subordinated securities. The Subordinated Indenture provides that the subordination provisions thereof will not apply to money and securities held in trust pursuant to the defeasance provisions of the Subordinated Indenture.

"Senior Indebtedness" is defined in the Subordinated Indenture as the principal of and premium, if any, and unpaid interest on

o our indebtedness (including indebtedness of others guaranteed by us), whether outstanding on the date of the Subordinated Indenture or thereafter created, incurred, assumed or guaranteed, for money borrowed, unless in the instrument creating or evidencing the same or pursuant to which the same is outstanding it is provided that such indebtedness is not senior or prior in right of payment to the junior subordinated debt securities, and

o renewals, extensions, modifications and refundings of any of this indebtedness.

The subordinated securities, are pari passu with and equal in right of payment to our 7.44% Deferrable Interest Subordinated Debentures, Series A, our Floating Rate Deferrable Interest Subordinated Debentures, Series B, our 7.25% Deferrable Interest Subordinated Debentures, Series C and any guarantees issued in connection therewith and will be pari passu with and equal in right of payment to any debt securities or guarantees which may be issued in connection with issuances of trust preferred securities by a Trust.

If this prospectus is being delivered in connection with a series of subordinated securities, the accompanying prospectus supplement or the information incorporated by reference therein will set forth the approximate amount of Senior Indebtedness outstanding as of a recent date.

Governing Law

The Indentures and the debt securities will be governed by, and construed in accordance with, the laws of the State of New Jersey.

The Trustee under the Senior Indenture and the Subordinated Indenture

Wachovia Bank, National Association, the Trustee under our Senior Indenture dated as of November 1, 1998 with respect to our senior debt securities, will also be trustee under the Subordinated Indenture with respect to our Subordinated Securities and the Trust Debt Indenture with respect to our trust debt securities. In the event that the Trustee's position as trustee under the Senior Indenture, the Subordinated Indenture and the Trust Debt Indenture creates a conflict for the Trustee, under certain circumstances, the Trustee will resign as trustee under one or more of the Senior Indenture, the Subordinated Indenture or the Trust Debt Indenture.

Wachovia Bank, National Association, is trustee under various indentures relating to our subsidiaries and affiliates. Our subsidiaries, our affiliates and we maintain other normal banking relationships, including credit facilities and lines of credit, with Wachovia Bank, National Association.

DESCRIPTION OF THE TRUST DEBT SECURITIES

General

If specified in the applicable prospectus supplement, the trust debt securities will be issued in one or more series under the Trust Debt Indenture to be entered into between us and Wachovia Bank, National Association. The initial series of trust debt securities to be issued thereunder is provided for in the form of the Trust Debt Indenture which is filed as an exhibit to the registration statement of which this prospectus is a part. The ranking of each series of trust debt securities will be specified in the applicable prospectus supplement. Each series of junior subordinated trust debt securities will rank subordinate and junior in right of payment, to the extent and in the manner set forth in the Trust Debt Indenture, to all of our Senior Indebtedness. See "--Subordination." The Trust Debt Indenture does not limit the incurrence or issuance of Senior Indebtedness by us. As used in this portion of the prospectus, the term "trust debt securities" means the debt securities to be issued under the Trust Debt Indenture that will comprise the assets of an issuing Trust and not any other debt securities that could comprise the assets of an issuing Trust.

You should read the relevant prospectus supplement for a description of the material terms of any series of trust debt securities being offered, including:

- the title of the series of trust debt securities;
- the aggregate principal amount of the series and any limit on the aggregate principal amount of such series of trust debt securities;
- the date or dates on which the principal of the trust debt securities of the series shall be payable or how the date or dates will be determined;
- the interest rate or rates, which may be fixed or variable, that the trust debt securities of the series will bear, if any, or how the rate or rates will be determined;
- any terms regarding redemption;
- the ranking of the series of trust debt securities;
- the maximum extension period for such series of trust debt securities; and
- any other material terms of the series of trust debt securities.

Certain federal income tax consequences and special considerations relating to the applicable series of trust debt securities will be described in an accompanying prospectus supplement.

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Option to Extend Interest Payment Period

Under the Trust Debt Indenture, we have the right to defer payments of interest by extending the interest payment period for a series of trust debt securities for up to the specified maximum extension period provided for that series, except that no extension period can extend beyond the maturity or any redemption date of that series of trust debt securities. We can also extend or shorten an existing extension period. At the end of an extension period, we will be obligated to pay all interest then accrued and unpaid (together with interest on those accrued and unpaid amounts to the extent permitted by applicable law). During any extension period, we may not declare or pay any dividend on, or redeem, purchase, acquire, or make a liquidation payment with respect to, any of our capital stock. Upon the termination of any extension period and the payment of all amounts then due, we can elect to begin a new extension period. We will be required to give notice to the Trustee and cause the Trustee to give notice to the holders of the applicable series of trust debt securities of our election to begin an extension period, or any shortening or extension of a period in advance of the applicable record date.

Subordination

Payments on the junior subordinated debt trust securities will be subordinated to the prior payment in full of all amounts payable on our Senior Indebtedness.

"Senior Indebtedness" is defined in the Trust Debt Indenture as the principal of and premium, if any, and unpaid interest on

- o our indebtedness (including indebtedness of others guaranteed by us), whether outstanding on the date of the Trust Debt Indenture or created later, incurred, assumed or guaranteed, for money borrowed, unless the terms of that indebtedness provide that it is not senior or prior in right of payment to the junior subordinated trust debt securities, and

- o renewals, extensions, modifications and refundings of that indebtedness.

Upon any payment or distribution of our assets or securities, upon our dissolution or winding-up or total or partial liquidation or reorganization, whether voluntary or involuntary, or in bankruptcy, insolvency, receivership or other proceedings, all amounts payable on Senior Indebtedness (including any interest accruing on the Senior Indebtedness after the commencement of a bankruptcy, insolvency or similar proceeding) will be paid in full before the holders of the junior subordinated trust debt securities will be entitled to receive from us any payment of principal of, premium, if any, or interest on, the junior subordinated trust debt securities or distributions of any assets or securities.

No direct or indirect payment by or on our behalf of principal of, premium, if any, or interest on, the junior subordinated trust debt securities will be made if there is

- o a default in the payment of all or any portion of any Senior Indebtedness or

- o any other default pursuant to which the maturity of Senior Indebtedness has been accelerated and, in either case, the required notice has been given to the Trustee and the default has not have been cured or waived by or on behalf of the holders of the Senior Indebtedness.

If the Trustee or any holder of the junior subordinated trust debt securities receives any payment of the principal of, premium, if any, or interest on, the junior subordinated trust debt securities when that payment is prohibited and before all amounts payable on Senior Indebtedness are paid in full, then that payment will be received and held in trust for the holders of Senior Indebtedness and will be paid to the holders of the Senior Indebtedness remaining unpaid to the extent necessary to pay the Senior Indebtedness in full.

Nothing in the Trust Debt Indenture limits the right of the Trustee or the holders of the junior subordinated trust debt securities to take any action to accelerate the maturity of the junior subordinated trust debt securities or to pursue any rights or remedies against us, as long as all Senior Indebtedness is paid before holders of the junior subordinated trust debt securities are entitled to receive any payment from us of principal of, premium, if any, or interest on, the junior subordinated trust debt securities.

Upon the payment in full of all Senior Indebtedness, the holders of the junior subordinated trust debt securities will be subrogated to the rights of the holders of the Senior Indebtedness to receive payments from us or distributions of our assets made on the Senior Indebtedness until the junior subordinated trust debt securities are paid in full.

Denominations, Registration and Transfer

Trust debt securities of a series are issuable only in registered form. The Trust Debt Indenture also provides that trust debt securities of a series may be issuable in global form. See "Description of the Senior and Subordinated Debt Securities -- Book-Entry Debt Securities." Unless otherwise provided in the prospectus supplement, trust debt securities (other than global securities, which may be of any denomination) are issuable in denominations of $1,000 or any integral multiples of $1,000.

Trust debt securities will be exchangeable for other registered securities of the same series. Registered securities of a series may be presented for registration of transfer and for exchange

- at each office or agency required to be maintained by us for payment of such series as described in "-- Payment and Paying Agents" below, and

- at each other office or agency that we may designate from time to time for those purposes.

No service charge will be made for any transfer or exchange of trust debt securities, but we may require payment of any tax or other governmental charge payable in connection with the transfer or exchange.

We will not be required to

- issue, register the transfer of or exchange trust debt securities during a period beginning at the opening of business 15 days before any selection of trust debt securities of that series to be redeemed and ending at the close of business on the day of mailing of the relevant notice of redemption;

- register the transfer of or exchange any trust debt security, or portion thereof, called for redemption, except the unredeemed portion of any trust debt security being redeemed in part; or

- issue, register the transfer of or exchange any trust debt security which has been surrendered for repayment at the option of the holder, except the portion, if any, of the trust debt security not to be so repaid.

Payment and Paying Agents

Unless otherwise provided in the prospectus supplement, premium, if any, and interest, if any, on trust debt securities will be payable at any office or agency to be maintained by us in Morristown, New Jersey and The City of New York, except that at our option interest may be paid

- by check mailed to the address of the person entitled thereto appearing in the security register or

- by wire transfer to an account maintained by the person entitled thereto as specified in the security register. Unless otherwise provided in the prospectus supplement, payment of any installment of interest due on any interest payment date for trust debt securities will be made to the person in whose name the trust debt security is registered at the close of business on the regular record date for that interest.

We may from time to time designate additional offices or agencies, approve a change in the location of any office or agency and, except as provided above, rescind the designation of any office or agency.

Certain Additional Covenants

We will covenant that we may not declare or pay any distribution on, or redeem, purchase, acquire or make a liquidation payment with respect to, any of our capital stock

- during an extension period,
- if there has occurred and is continuing an event of default under the Trust Debt Indenture, or
- if we are in default under the preferred securities guarantee.

Any waiver of any event of default will require the approval of at least a majority of the aggregate principal amount of the trust debt securities of a particular series or, if the trust debt securities are held by the Trust, the approval of the holders of at least a majority in aggregate liquidation amount of the preferred trust securities of the Trust; except that an event of default resulting from the failure to pay the principal of, premium, if any, or interest on, the trust debt securities cannot be waived.

Modification of the Trust Debt Indenture

We and the Trustee, without notice to or the consent of any holders of trust debt securities, may amend or supplement the Trust Debt Indenture for any of the following purposes:

- to cure any ambiguity, defect or inconsistency;
- to comply with the provisions of the Trust Debt Indenture regarding consolidation, merger or sale, conveyance, transfer or lease of our properties as an entirety or substantially as an entirety;
- to provide for uncertificated trust debt securities in addition to or in place of certificated trust debt securities;
- to make any other change that does not in our reasonable judgment adversely affect the rights of any holder of the trust debt securities; or
- to set forth the terms and conditions, which shall not be inconsistent with the Trust Debt Indenture, of any additional series of trust debt securities and the form of trust debt securities of that series.

In addition, we and the Trustee may modify the Trust Debt Indenture or any supplemental indenture or waive our future compliance with the provisions of the Trust Debt Indenture, with the consent of the holders of at least a majority of the aggregate principal amount of the trust debt securities of each affected series except that we need the consent of each holder of affected trust debt securities, for any modification that would:

- reduce the principal amount of, or interest on, the trust debt securities or change how the principal or interest is calculated;
- reduce the principal amount of outstanding trust debt securities of any series the holders of which must consent to an amendment of the Trust Debt Indenture or a waiver;

- change the stated maturity of the principal of, or interest on, the trust debt securities;
- change the redemption provisions applicable to the trust debt securities adversely to the holders thereof;
- impair the right to institute suit for the enforcement of any payment with respect to the trust debt securities;
- change the currency in which payments with respect to the trust debt securities are to be made; or
- change the ranking provisions applicable to the trust debt securities adversely to the holders thereof.

If the trust debt securities are held by the Trust, no modification will be made that adversely affects the holders of the preferred trust securities of the Trust, and no waiver of any event of default with respect to the trust debt securities or compliance with any covenant under the Trust Debt Indenture will be effective, without the prior consent of the holders of at least a majority of the aggregate liquidation amount of the preferred trust securities of the Trust or the holder of each preferred trust security, as applicable.

Events of Default

The following are events of default under the Trust Debt Indenture with respect to any series of trust debt securities unless we state otherwise in the applicable prospectus supplement:

- we do not pay interest on a trust debt security of the series within 30 days of its due date (other than the deferral of interest payments during an extension period);
- we do not pay the principal of, or premium on, a trust debt security of the series on its due date;
- we remain in breach of a covenant in respect of the trust debt securities of the series for 60 days after we receive written notice of default stating we are in breach;
- we file for bankruptcy or a court appoints a custodian or orders our liquidation under any bankruptcy law or certain other events of bankruptcy, insolvency or reorganization occur.

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In case an event of default has occurred and is continuing, other than one relating to bankruptcy, insolvency or reorganization affecting us in which case the principal of, premium, if any, and any interest on, all of the trust debt securities shall become immediately due and payable, the Trustee or the holders of at least 25% in aggregate principal amount of the trust debt securities of that series may declare the principal, together with interest accrued thereon, of all the trust debt securities of that series to be due and payable. If neither the Trustee nor the holders make that declaration then, if the trust debt securities are held by the Trust, the holders of at least 25% in aggregate liquidation amount of the preferred trust securities shall have the right to make that declaration by written notice to us and the Trustee. The holders of at least a majority in aggregate principal amount of the series of trust debt securities, by notice to the Trustee, can rescind an acceleration, but if the declaration was made by the holders of the preferred trust securities, the holders of at least a majority in aggregate liquidation amount of the preferred trust securities must consent to the rescission of the acceleration. We will be required to furnish to the Trustee an annual statement as to our compliance with all conditions and covenants under the Trust Debt Indenture and the trust debt securities and as to any event of default.

Consolidation, Merger, Sale or Conveyance

We may not consolidate with or merge with or into any other person or sell, convey, transfer or lease our properties and assets as an entirety or substantially as an entirety to any person, unless

- the successor person is organized under the laws of the United States or any state thereof or the District of Columbia and expressly assumes by a supplemental indenture all of our obligations under the trust debt securities and the Trust Debt Indenture;

- immediately after the transaction, no default exists; and

- certain other conditions in the Trust Debt Indenture are met.

Defeasance and Discharge

Under the terms of the Trust Debt Indenture, we will be discharged from any and all obligations in respect of the trust debt securities of any series if, among other conditions, we deposit with the Trustee, in trust, (1) cash and/or (2) U.S. government or U.S. government agency notes or bonds that will generate enough cash to make interest principal and other payments on the trust debt securities on their various due dates.

Information Concerning the Trustee

Subject to the provisions of the Trust Debt Indenture relating to its duties, the Trustee will be under no obligation to exercise any of its rights or powers under the Trust Debt Indenture at the request or direction of the holders of any series of trust debt securities or the holders of the preferred trust securities, unless those holders provide to the Trustee reasonable security and indemnity. If the required indemnity is provided, the holders of at least a majority in aggregate principal amount of any series of trust debt securities affected or the holders of at least a majority in aggregate liquidation amount of the preferred trust securities (with each series voting as a class), as applicable, will have the right to direct the time, method and place of conducting any proceeding for any remedy available to the Trustee with respect to that series of trust debt securities or exercising any trust or power conferred on the Trustee.

The Trust Debt Indenture will contain limitations on the right of the Trustee, as our creditor, to obtain payment of claims in certain cases, or to realize on certain property received in respect of any such claim as security or otherwise. In addition, the Trustee may be deemed to have a conflicting interest and may be required to resign as Trustee if at the time of an event of default (1) it is our creditor or (2) there is a default under the indenture(s) referred to below.

Wachovia Bank, National Association will be the Trustee under our Trust Debt Indenture and also is the trustee under our Senior Indenture and will be trustee under our Subordinated Indenture. In the event that the Trustee's position as trustee under the Senior Indenture, the Subordinated Indenture and the Trust Debt Indenture creates a conflict for the Trustee, under certain circumstances, the Trustee will resign as trustee under one or more of the Senior Indenture, the Subordinated Indenture or the Trust Debt Indenture.

Wachovia Bank, National Association is also the trustee under various indentures relating to our subsidiaries and affiliates. Our subsidiaries, our affiliates and we maintain other normal banking relationships, including credit facilities and lines of credit, with Wachovia Bank, National Association.

Governing Law

The Trust Debt Indenture and the trust debt securities will be governed by and construed in accordance with the laws of the State of New Jersey.

DESCRIPTION OF THE PREFERRED TRUST SECURITIES

Each Trust may issue preferred trust securities and common trust securities under its Trust Agreement, which we refer to in this prospectus as the "trust securities." Material provisions of the Trust Agreements are summarized below. Because this section is a summary, it does not describe every aspect of the trust securities and the Trust Agreements. The form of Trust Agreement for each Trust was filed with the SEC and you should read the Trust Agreement for each Trust for provisions that may be important to you. The Trust Agreements have been qualified as indentures under the Trust Indenture Act of 1939.

General

Each Trust Agreement authorizes the respective Trust to issue its preferred trust securities and its common trust securities. These trust securities of each Trust will represent undivided beneficial interests in the assets of that Trust. We will own all of the issued and outstanding common trust securities of each Trust, with an aggregate liquidation amount equal to at least 3% of the total capital of that Trust. When a Trust issues its preferred trust securities, holders of the preferred trust securities will own all of the issued and outstanding preferred trust securities of that Trust. The preferred trust securities will be substantially identical to the common trust securities and will rank equally with the common trust securities, except as described under "Subordination of Common Trust Securities." The proceeds from the sale of the preferred trust securities and the common trust securities will be used by the issuing Trust to purchase our trust debt securities described above under "Description of the Trust Debt Securities" or such other debt securities as are specified in the applicable prospectus supplement which will be held in trust by the property trustee for the benefit of the holders of the trust securities. We will execute a guarantee agreement for the benefit of the holders of preferred trust securities (the "guarantee") which will have the ranking specified in the applicable prospectus supplement. Under the guarantee, we will agree to make payments of distributions and payments on redemption or liquidation with respect to the preferred trust securities, but only to the extent the issuing Trust holds funds available for these payments and has not made them. See "Description of the Preferred Securities Guarantee" below.

A prospectus supplement relating to the preferred trust securities of a Trust will include specific terms of those securities and of the related trust debt securities. As used in this portion of the prospectus, the term "trust debt securities" relates to the debt securities that will comprise the assets of the issuing Trust.

Distributions

The only income of an issuing Trust available for distribution to the holders of its preferred trust securities will be payments on the related trust debt securities. If we fail to make interest payments on the related trust debt securities, the issuing Trust will not have funds available to pay distributions on its preferred trust securities. The payment of distributions, if and to the extent the issuing Trust has sufficient funds available for the payment of such distributions, will be guaranteed by us as described below.

Distributions on the preferred trust securities of a Trust will be payable at a rate specified (or at a rate whose method of determination is described) in an accompanying prospectus supplement. Unless otherwise specified in the prospectus supplement, the amount of distributions payable for any period will be computed on the basis of a 360-day year of twelve 30-day months.

Unless otherwise specified in the prospectus supplement, distributions on the preferred trust securities will be cumulative and will accumulate whether or not there are funds of the issuing Trust available for payment of distributions from the date of original issuance and will be payable in arrears on the dates specified in the prospectus supplement except as otherwise described below. Unless otherwise specified in the prospectus

supplement, distribution payments due on a day that is not a business day will be made on the next day that is a business day (and without any interest or other payment in respect to the delay), except that if the next business day falls in the next calendar year, payment will be made on the immediately preceding business day (each date on which distributions are payable as described is referred to as a "distribution date"). Unless otherwise specified in the prospectus supplement, a "business day" means any day other than a Saturday, Sunday or a day on which banks in The City of New York or the State of New Jersey are required to remain closed.

Distributions on the preferred trust securities of a Trust will be payable to the holders thereof as they appear on the securities register of that Trust on the relevant record date, which, as long as the preferred trust securities remain in book-entry-only form, will be one business day prior to the relevant distribution date. Payments will be made as described under "Description of the Senior and Subordinated Debt Securities -- Book-Entry Debt Securities." In the event that any preferred trust securities of a Trust are not in book-entry-only form, the relevant record date for those preferred trust securities will be specified in the applicable prospectus supplement.

So long as no event of default has occurred and is continuing with respect to the trust debt securities of a Trust, we will have the right to time to defer payments of interest by extending the interest payment period on the related trust debt securities for up to the maximum period specified in the accompanying prospectus supplement except that no extension period can extend beyond the maturity or any redemption date of the trust debt securities. We can also extend or shorten an existing extension period. If interest payments on a series of trust debt securities are deferred, distributions on the related preferred trust securities would also be deferred by the issuing Trust during that extension period, but the amount of distributions to which holders of those preferred trust securities would be entitled will continue to accumulate at the annual rate applicable to those distributions, compounded with the same frequency with which distributions are payable. During any extension period, we may not declare or pay any distribution on, or redeem, purchase, acquire, or make a liquidation payment with respect to, any of our capital stock. Upon the termination of any extension period and the payment of all amounts then due, we can elect to begin a new extension period. See "Description of the Trust Debt Securities -- Option to Extend Interest Payment Period."

Redemption

Upon the payment of a series of trust debt securities at maturity or upon redemption, the proceeds from that payment will be applied by the respective property trustee to redeem the same amount of the related trust securities at a redemption price equal to the liquidation amount of those trust securities plus all accumulated and unpaid distributions to the redemption date. The redemption terms of the trust debt securities and the related trust securities will be set forth in the accompanying prospectus supplement.

If less than all the trust securities of a Trust are to be redeemed on a redemption date, then the aggregate amount of trust securities to be redeemed will be selected by the property trustee among the preferred trust securities and common trust securities of that Trust pro rata based on the respective aggregate liquidation amounts of the preferred trust securities and common trust securities, subject to the provisions of "-- Subordination of Common Trust Securities" below.

Redemption Procedures

Notice of any redemption of trust securities of a Trust will be given by the property trustee to the holders of the trust securities to be redeemed not less than 30 nor more than 60 days prior to the redemption date. If a notice of redemption is given with respect to any trust securities of a Trust, then, to the extent funds are available therefor, that Trust will irrevocably deposit with the paying agent for those trust securities funds sufficient to pay the applicable redemption price for the trust securities being redeemed on the redemption date and will give the paying agent irrevocable instructions and authority to pay the redemption price to the holders of those trust securities upon surrender thereof. Notwithstanding the foregoing, distributions payable on or prior to the redemption date for any trust securities called for redemption shall be payable to the holders of the trust securities as they appear on the securities register for those trust securities on the relevant record dates for the related distribution dates.

If notice of redemption shall have been given and funds irrevocably deposited as required, then upon the date of such deposit, all rights of the holders of the trust securities of a Trust so called for redemption will

cease, except the right of the holders of the trust securities to receive the redemption price, but without interest thereon, and the trust securities will cease to be outstanding. In the event that any redemption date for trust securities of a Trust is not a business day, then the redemption price will be payable on the next day that is a business day (and without any interest or other payment in respect of any such delay), except that if such business day falls in the next calendar year, the redemption price will be payable on the immediately preceding business day. In the event that payment of the redemption price in respect of any trust securities called for redemption is improperly withheld or refused and not paid either by the Trust thereof or by us pursuant to the guarantee as described under "Description of the Preferred Securities Guarantee," Distributions on those trust securities will continue to accumulate at the then applicable rate from the original redemption date to the date of payment, in which case the actual payment date will be considered the redemption date for purposes of calculating the redemption price.

Subject to applicable law, including United States federal securities law, we or our affiliates may at any time and from time to time purchase outstanding preferred trust securities of a Trust by tender, in the open market or by private agreement.

If preferred trust securities of a Trust are partially redeemed on a redemption date, a corresponding percentage of the common trust securities of that Trust will also be redeemed. The particular preferred trust securities to be redeemed will be selected by the property trustee of that Trust by such method as the property trustee shall deem fair and appropriate. The property trustee will promptly notify the preferred trust security registrar in writing of the preferred trust securities selected for redemption and, where applicable, the partial amount to be redeemed.

Subordination of Common Trust Securities

Payments on the trust securities of a Trust will be made pro rata based on the respective aggregate liquidation amounts of that Trust's common and preferred trust securities. If an event of default has occurred and is continuing with respect to the trust debt securities of a Trust, no payments will be made on any common trust securities of that Trust unless payment in full in cash of all accumulated and unpaid distributions on all outstanding preferred trust securities of that Trust for all distribution periods terminating on or prior to that time, or in the case of a dissolution or redemption, the full amount of the redemption price or liquidation distribution on all outstanding preferred trust securities of that Trust shall have been made or provided for, and all funds available to the property trustee shall first be applied to the payment in full in cash of all payments on all outstanding preferred trust securities of that Trust then due and payable.

If an event of default has occurred and is continuing with respect to the trust debt securities of a Trust, the holder of the common trust securities of that Trust will be deemed to have waived any right to act with respect to the event of default until the effect of the event of default has been cured, waived or otherwise eliminated with respect to those preferred trust securities. Until the event of default has been cured, waived or otherwise eliminated, the property trustee of that Trust shall act solely on behalf of the holders of the preferred trust securities of that Trust and not on behalf of us, as holder of its common trust securities, and only the holders of the preferred trust securities will have the right to direct the property trustee to act on their behalf.

Liquidation Distribution upon Dissolution

Under each Trust Agreement, a Trust will be dissolved on the earliest to occur of:

- the expiration of the term of that Trust;
- our bankruptcy, dissolution or liquidation or an acceleration of the maturity of the trust debt securities held by that Trust;
- our election to dissolve that Trust and, after satisfaction of liabilities to creditors of that Trust, the distribution of the related trust debt securities to the holders of that Trust's trust securities;
- the redemption of all the trust securities of that Trust; and
- an order for the dissolution of that Trust entered by a court of competent jurisdiction.

Our election to dissolve a Trust shall be made by giving written notice to the trustees of that Trust not less than 30 days prior to the date of distribution of its trust debt securities and shall be accompanied by a legal opinion stating that the event will not be a taxable event to the holders of the trust securities for federal income tax purposes.

If a Trust is dissolved as a result of the expiration of its term, a bankruptcy event, acceleration of maturity of the related trust debt securities or a court order, it will be liquidated by its trustees as expeditiously as the trustees determine to be possible by distributing, after satisfaction of liabilities to its creditors as provided by applicable law, to the holders of its trust securities a like amount of the related trust debt securities, unless that distribution is determined by the property trustee not to be practical, in which event holders will be entitled to receive out of that Trust's assets available for distribution to holders, after satisfaction of liabilities to its creditors as provided by applicable law, an amount equal to the aggregate liquidation amount per trust security specified in the accompanying prospectus supplement plus accumulated and unpaid distributions to the date of payment (the "liquidation distribution"). If the liquidation distribution with respect to the preferred trust securities of a Trust can be paid only in part because that Trust has insufficient assets available to pay in full the aggregate liquidation distribution, then the amounts payable by that Trust on its preferred trust securities shall be paid on a pro rata basis. The holders of its common trust securities will be entitled to receive the liquidation distribution upon any liquidation pro rata with the holders of preferred trust securities, except that if an event of default has occurred and is continuing, the preferred trust securities will have a priority over the common trust securities with respect to payment of the liquidation distribution.

Trust Agreement Event of Default; Notice

An event of default with respect to the related trust debt securities will constitute a "Trust Agreement event of default" with respect to the preferred trust securities of a Trust.

Within 90 days after the occurrence of any Trust Agreement event of default actually known to the property trustee of a Trust, the property trustee will send notice of it to the holders of the trust securities of that Trust, its administrative trustee and us, unless the default has been cured or waived. We and the administrative trustee of each Trust are required to file annually with the property trustee of that Trust a certificate as to whether or not we are in compliance with all the conditions and covenants applicable to us under its Trust Agreement.

Under the Trust Agreement for each Trust, if the property trustee has failed to enforce its rights under the Trust Agreement or the related Trust Debt Indenture to the fullest extent permitted by law and subject to the terms of the Trust Agreement and the related Trust Debt Indenture, any holder of the preferred trust securities of that Trust may institute a legal proceeding directly to enforce the property trustee's rights under that Trust Agreement or the Trust Debt Indenture with respect to trust debt securities having an aggregate principal amount equal to the aggregate liquidation amount of the preferred trust securities of such holder without first instituting a legal proceeding against the property trustee or any other person. To the extent that any action under a Trust Debt Indenture is entitled to be taken by the holders of at least a specified percentage of the principal amount of the related trust debt securities, holders of that specified percentage of the preferred trust securities may take that action if it is not taken by the property trustee. If a Trust Agreement event of default attributable to our failure to pay principal of or premium, if any, or interest on a series of trust debt securities has occurred and is continuing, then each holder of related preferred trust securities may institute a legal proceeding directly against us for enforcement of payment to that holder, all as provided in the related Trust Debt Indenture.

If an event of default has occurred and is continuing with respect to a series of trust debt securities, the related preferred trust securities of a Trust will have a preference over the common trust securities of that Trust with respect to the payment of distributions and amounts payable on redemption and liquidation as described above. See " Liquidation Distribution upon Dissolution" and "-- Subordination of Common Trust Securities."

Removal of Trustees

Unless a Trust Agreement event of default has occurred and is continuing, we, as the holder of the common trust securities of a Trust, may remove any trustee of that Trust under its trust agreement at any time. If a Trust Agreement event of default has occurred and is continuing, the holders of a majority of the total liquidation amount of the outstanding preferred trust securities of that Trust may remove its property trustee or

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the Delaware trustee, or both of them. We, as the holder of the common trust securities of a Trust, may remove its administrative trustee at any time. Any resignation or removal of a trustee under the trust agreement of a Trust will take effect only on the acceptance of appointment by the successor trustee.

Holders of preferred trust securities of a Trust will have no right to appoint or remove the administrative trustee of that Trust, who may be appointed, removed or replaced solely by us as the holder of the common trust securities of that Trust.

Co-Trustees and Separate Property Trustee

Unless a Trust Agreement event of default has occurred and is continuing, in order to meet various legal requirements, the holder of the common trust securities of a Trust and its administrative trustee shall have the power

- to appoint one or more persons approved by the property trustee of that Trust either to act as co-trustee, jointly with the property trustee, of all or any part of specified trust property, or to act as separate trustee of that trust property, and

- to vest in that person or persons in that capacity any property, title, right or power deemed necessary or desirable, subject to the provisions of the Trust Agreement of that Trust.

If a Trust Agreement event of default has occurred and is continuing, only the property trustee of that Trust will have power to make this appointment.

Merger or Consolidation of Trustees

Any corporation or other entity into which any trustee may be merged or converted or with which it may be consolidated, or any corporation or other entity resulting from any merger, conversion or consolidation to which any trustee shall be a party, or any corporation or other entity succeeding to all or substantially all the corporate trust business of any trustee, shall be the successor of such trustee under the Trust Agreement of a Trust, as long as the corporation or other entity is otherwise qualified and eligible.

Mergers, Consolidations, Amalgamations or Replacements of a Trust

A Trust may not merge with or into, consolidate, amalgamate, or be replaced by, or convey, transfer or lease its properties and assets as an entirety or substantially as an entirety to any corporation or other entity, except as described below or in "-- Liquidation Distribution upon Dissolution." Each Trust may, at our request, with the consent of its administrative trustee and without the consent of the holders of its trust securities, merge with or into, consolidate, amalgamate, or be replaced by a trust organized under the laws of any state, as long as

- the successor entity either
  - expressly assumes all of the obligations of that Trust with respect to its trust securities or
  - substitutes for the trust securities of that Trust other securities substantially similar to those trust securities (the "successor securities") so long as the successor securities rank the same as those trust securities with respect to the payment of distributions and payments upon redemption, liquidation and otherwise;
- we appoint a trustee of the successor entity with the same powers and duties as the property trustee of that Trust with respect to the related trust debt securities;
- the successor securities are listed on any national securities exchange or other organization on which the trust securities of that Trust are then listed;
- the merger, consolidation, amalgamation, replacement, conveyance, transfer or lease does not cause the rating of preferred trust securities of that Trust (including any successor securities) to be downgraded, placed under surveillance or review or withdrawn by any nationally recognized statistical rating organization;

- the merger, consolidation, amalgamation, replacement, conveyance, transfer or lease does not adversely affect the rights, preferences and privileges of the holders of the trust securities of that Trust (including any successor securities) in any material respect;
- the successor entity has a purpose substantially similar to that of the original Trust;
- prior to the merger, consolidation, amalgamation, replacement, conveyance, transfer or lease, we and the property trustee of that Trust have received a legal opinion stating that
  - such merger, consolidation, amalgamation, replacement, conveyance, transfer or lease does not adversely affect the rights, preferences and privileges of the holders of the trust securities of that Trust (including any successor securities) in any material respect, and
  - following the merger, consolidation, amalgamation, replacement, conveyance, transfer or lease neither the Trust nor the successor entity will be required to register as an investment company

under the Investment Company Act of 1940, and the Trust (or the successor entity) will continue to be classified as a grantor trust for United States federal income tax purposes; and

- we or any permitted successor assignee own all of the common securities of the successor entity and guarantee the obligations of the successor entity under the successor securities at least to the extent provided by the related guarantee and Trust Agreement.

No Trust will, except with the consent of all holders of its trust securities, consolidate, amalgamate, merge with or into, or be replaced by, any other entity, or permit any other entity to consolidate, amalgamate, merge with or into, or replace it if that action would cause that Trust or the successor entity not to be classified as a grantor trust for federal income tax purposes.

Voting Rights; Amendment of a Trust Agreement

Except as provided below and under "-- Mergers, Consolidations, Amalgamations or Replacements of a Trust" and "Description of the Preferred Securities Guarantee -- Amendments and Assignment" and as otherwise required by law and the applicable Trust Agreement, the holders of the trust securities of a Trust will have no voting rights.

Each Trust Agreement may be amended from time to time by us and the trustees of that Trust, without the consent of the holders of the trust securities of that Trust, (1) to cure any ambiguity, defect or inconsistency or (2) to make any other change that does not adversely affect in any material respect the interests of any holder of the preferred trust securities of that Trust.

Each Trust Agreement may be amended by us and the trustees of that Trust in any other respect, with the consent of the holders of a majority in aggregate liquidation amount of the outstanding preferred trust securities of that Trust, except to

- change the amount, timing or currency or otherwise adversely affect the method of payment of any distribution or liquidation distribution,

- restrict the right of a holder of any preferred trust securities of that Trust to institute suit for enforcement of any distribution, redemption price or liquidation distribution,

- change the purpose of that Trust,

- authorize the issuance of any additional beneficial interests in that Trust,

- change the redemption provisions,

- change the conditions precedent for us to elect to dissolve that Trust and distribute the trust debt securities to the holders of the preferred trust securities of that Trust or

- affect the limited liability of any holder of the preferred trust securities of that Trust, which amendment requires the consent of each affected holder of those preferred trust securities.

No amendment may be made without receipt by the applicable Trust of a legal opinion stating that the amendment will not affect that Trust's status as a grantor trust for federal income tax purposes or its exemption from regulation as an investment company under the Investment Company Act of 1940.

The Trustees of each Trust shall not

- direct the time, method and place of conducting any proceeding for any remedy available to a trustee under the Trust Debt Indenture or executing any trust or power conferred on that trustee with respect to the trust debt securities of that Trust,
- waive any past default under the Trust Debt Indenture,
- exercise any right to rescind or annul an acceleration of the principal of the trust debt securities of that Trust or
- consent to any amendment or modification of the Trust Debt Indenture, where consent shall be required,

without, in each case, obtaining the consent of the holders of a majority in aggregate liquidation amount of all outstanding preferred trust securities of that Trust; provided, however, that where a consent under the Trust Debt Indenture would require the consent of each affected holder of trust debt securities of that Trust, no consent shall be given by the property trustee of that Trust without the prior consent of each holder of those preferred trust securities. The trustees shall not revoke any action previously authorized or approved by a vote of the holders of the preferred trust securities of that Trust except by subsequent vote of those holders. The property trustee shall notify all holders of preferred trust securities of that Trust of any notice received from the trustee under the Trust Debt Indenture as a result of the issuer thereof being the holder of the trust debt securities. In addition to obtaining the consent of the holders of the preferred trust securities of that Trust prior to taking any of these actions, the trustees shall obtain a legal opinion stating that the Trust will not be classified as an association taxable as a corporation or a partnership for federal income tax purposes as a result of that action and will continue to be classified as a grantor trust for federal income tax purposes.

Any required consent of holders of preferred trust securities of a Trust may be given at a meeting of holders of the preferred trust securities convened for that purpose or pursuant to written consent without a meeting and without prior notice. The property trustee of a Trust will cause a notice of any meeting at which holders of preferred trust securities are entitled to vote, to be given to each holder of record of preferred trust securities of that Trust in the manner set forth in the Trust Agreement.

Notwithstanding that holders of preferred trust securities of a Trust are entitled to vote or consent under certain circumstances, any preferred trust securities of a Trust that are owned by us, the Trustees or any affiliate of ours or any Trustee shall, for purposes of a vote or consent, be treated as if they were not outstanding.

Global Preferred Trust Securities

Unless otherwise specified in the applicable prospectus supplement, the preferred trust securities of a Trust will initially be issued in fully registered global form that will be deposited with, or on behalf of, a depositary. Global preferred trust securities may be issued only in fully registered form and in either temporary or permanent form. Unless and until a global preferred trust security is exchanged in whole or in part for the individual preferred trust securities represented thereby, the depositary holding the global preferred trust security may transfer the global preferred trust security only to its nominee or successor depositary or vice versa and only as a whole. Unless otherwise indicated in the applicable prospectus supplement, the depositary for the global preferred trust securities will be DTC. The laws of some jurisdictions require that certain purchasers of securities take physical delivery of such securities in certificated form. These limits and laws may impair the ability to transfer beneficial interests in global preferred trust securities. See "Description of the Senior and Subordinated Debt Securities -- Book-Entry Debt Securities" for a description of DTC and its procedures.

Information Concerning the Property Trustee

The property trustee of each Trust is the sole trustee under the applicable Trust Agreement for purposes of the Trust Indenture Act of 1939 and will have and be subject to all of the duties and responsibilities of an indenture trustee under the Trust Indenture Act of 1939. The property trustee, other than during the occurrence and continuance of a Trust Agreement event of default, undertakes to perform only such duties as are specifically set forth in the applicable Trust Agreement and, upon a Trust Agreement event of default, must use the same degree of care and skill in the exercise thereof as a prudent person would exercise or use in the conduct of his or her own affairs. Subject to this provision, the property trustee is under no obligation to

exercise any of the powers vested in it by the applicable Trust Agreement at the request of any holder of preferred trust securities of that Trust unless it is offered reasonable security or indemnity against the costs, expenses and liabilities that might be incurred thereby. If no Trust Agreement event of default has occurred and is continuing, and the property trustee is required to decide between alternative courses of action, construe ambiguous provisions in the applicable Trust Agreement or is unsure of the application of any provision of that Trust Agreement, and the matter is not one on which holders of preferred trust securities of that Trust are entitled under the applicable Trust Agreement to vote, then the property trustee shall take such action as is directed by us and, if not so directed, may take such action as it deems advisable and in the best interests of the holders of the trust securities of that Trust and will have no liability except for its own negligent action, negligent failure to act or willful misconduct.

Wachovia Bank, National Association is the property trustee of each Trust. Wachovia Bank, National Association is also the trustee under our Senior Debt Indenture and will be the trustee under our Subordinated Indenture and our Trust Debt Indenture. In the event that the property trustee's position as trustee under the Senior Indenture, the Subordinated Indenture or the Trust Debt Indenture creates a conflict for the property trustee, under certain circumstances, the property trustee will resign as property trustee or as trustee under one or more of the Senior Indenture, the Subordinated Indenture or the Trust Debt Indenture.

Wachovia Bank, National Association is also the trustee under various indentures relating to our subsidiaries and affiliates. Our subsidiaries, our affiliates and we maintain other normal banking relationships, including credit facilities and lines of credit, with Wachovia Bank, National Association.

Books and Records

The books and records of each Trust will be maintained at the principal office of the respective Trust and will be open for inspection by each holder of preferred trust securities of that Trust or any authorized representative for any purpose reasonably related to the holder's interest in that Trust during normal business hours.

Payment of Preferred Trust Securities and Paying Agent

Unless we indicate differently in a prospectus supplement, payments in respect of the preferred trust securities of a Trust will be made to the depositary, which will credit the relevant participants' accounts on the applicable distribution dates or, if the preferred trust securities of that Trust are not held by the depositary, payments will be made on the applicable distribution dates by check mailed to the address of the holder entitled thereto appearing on the preferred trust security register or in immediately available funds upon redemption. The paying agent will initially be the property trustee of that Trust and any co-paying agent chosen by that property trustee and acceptable to the administrative trustee of that Trust and us, which may be us. A paying agent may resign upon 30 days' written notice to the administrative trustee, the applicable property trustee and us. In the event that the property trustee shall no longer be the paying agent, the administrative trustee of that Trust will appoint a successor, which shall be a bank, trust company or affiliate of ours acceptable to the property trustee and us to act as paying agent.

Registrar and Transfer Agent

The property trustee of each Trust will act as registrar and transfer agent for the preferred trust securities of that Trust. Registration of transfers of preferred trust securities will be made without charge by or on behalf of the applicable Trust, but that Trust may require payment of any tax or other governmental charges that may be imposed in connection with any transfer or exchange of its preferred trust securities.

Miscellaneous

Holders of the preferred trust securities of each Trust have no preemptive or similar rights.

Governing Law

Each Trust Agreement, the preferred trust securities of each Trust and the common trust securities of each Trust provide that they are to be governed by and construed in accordance with the laws of the State of Delaware.

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DESCRIPTION OF THE PREFERRED SECURITIES GUARANTEE

Material provisions of each preferred securities guarantee that we will execute and deliver for the benefit of the holders of preferred trust securities of a Trust are summarized below. Because this section is a summary, it does not describe every aspect of the preferred securities guarantees. The form of preferred securities guarantee for each Trust was filed with the SEC and you should read it for provisions that may be important to you. The preferred securities guarantee of each Trust has been qualified as an indenture under the Trust Indenture Act of 1939.

Wachovia Bank, National Association, will act as guarantee trustee under each preferred securities guarantee. The guarantee trustee will hold the preferred securities guarantee for the benefit of the holders of the preferred trust securities of the respective Trust.

General

We will irrevocably agree, to pay in full, to the holders of the preferred trust securities of the applicable Trust, the guarantee payments set forth below (except to the extent previously paid), as and when due, regardless of any defense, right of set-off or counterclaim which the applicable Trust may have or assert. The following payments, to the extent not paid by the applicable Trust, will be subject to the applicable guarantee:

- any accumulated and unpaid distributions required to be paid on the preferred trust securities of a Trust, to the extent that that Trust has funds available therefor,
- the redemption price, to the extent that the applicable Trust has funds available therefor, and
- upon a voluntary or involuntary termination, winding-up or liquidation of the applicable Trust (unless the trust debt securities of that Trust are redeemed or distributed to holders of the preferred trust securities applicable in accordance with their terms), the lesser of
  - the aggregate of the liquidation amount specified in the prospectus supplement per preferred trust security of that Trust plus all accumulated and unpaid distributions on those preferred trust securities to the date of payment, to the extent the applicable Trust has funds available therefor and
  - the amount of assets of the applicable Trust remaining available for distribution to holders of the preferred trust securities of that Trust upon a dissolution and liquidation of that Trust.

Our obligation to make a guarantee payment may be satisfied by direct payment by us of the required amounts to the holders of the preferred trust securities or by causing the applicable Trust to pay those amounts to the holders. While our assets will not be available pursuant to the guarantee for the payment of any distribution, liquidation distribution or redemption price on any preferred trust securities if the applicable Trust does not have funds available therefor as described above, we have agreed under the applicable Trust Agreement to pay all expenses of that Trust except its obligations under its trust securities.

No single document executed by us in connection with the issuance of the preferred trust securities of any Trust will provide for our full, irrevocable and unconditional guarantee of the preferred trust securities of that Trust. It is only the combined operation of our obligations under the applicable guarantee, the applicable Trust Agreement, the applicable trust debt securities and the Trust Debt Indenture that has the effect of providing a full, irrevocable and unconditional guarantee of a Trust's obligations under its preferred trust securities. See "Relationship Among the Preferred Trust Securities, the Trust Debt Securities and the Preferred Securities Guarantee."

Status of the Guarantee

The guarantee will constitute our unsecured obligation and will have the ranking specified in the applicable prospectus supplement. Each Trust Agreement provides that each holder of preferred trust securities of that Trust by acceptance thereof agrees to the terms of the guarantee including, if specified in the prospectus supplement, subordination provisions relating to the guarantee. The guarantee will constitute a guarantee of payment and not of collection (i.e., the guaranteed party may institute a legal proceeding directly against us to enforce its rights under the guarantee without first instituting a legal proceeding against any other person or entity). The guarantee will not be discharged except by payment of the guarantee payments in full to the extent

not previously paid or upon distribution to the holders of the preferred trust securities of the applicable Trust of the related trust debt securities pursuant to the applicable trust agreement.

Amendments and Assignment

Except with respect to any changes that do not materially adversely affect the rights of holders of the preferred trust securities of a Trust (in which case no consent of the holders will be required), the guarantee with respect to any Trust may only be amended with the prior approval of the holders of a majority in aggregate liquidation amount of the preferred trust securities of a Trust (excluding any preferred trust securities held by us or an affiliate). The manner of obtaining any approval will be as set forth under "Description of the Preferred Trust Securities -- Voting Rights; Amendment of a Trust Agreement." All agreements contained in each guarantee will bind our successors, assigns, receivers, trustees and representatives and will inure to the benefit of the holders of the preferred trust securities of the applicable Trust.

Guarantee Events of Default

An event of default under a guarantee (a "guarantee event of default") will occur upon our failure to perform any of our payment or other obligations thereunder, provided that except with respect to a guarantee event of default resulting from a failure to make any of the guarantee payments, we shall have received notice of the guarantee event of default from the applicable guarantee trustee and shall not have cured such guarantee event of default within 60 days after receipt of such notice. The holders of a majority in aggregate liquidation amount of the preferred trust securities of a Trust (excluding any preferred trust securities held by us or an affiliate) will have the right to direct the time, method and place of conducting any proceeding for any remedy available to the guarantee trustee under the guarantee related to that Trust or to direct the exercise of any trust or power conferred upon the respective guarantee trustee under the guarantee.

Any holder of the preferred trust securities of a Trust may institute a legal proceeding directly against us to enforce that holder's rights under the related guarantee without first instituting a legal proceeding against the applicable Trust, the applicable guarantee trustee or any other person or entity.

We, as guarantor, will be required to file annually with each guarantee trustee a certificate as to whether or not we are in compliance with all the conditions and covenants applicable to us under the applicable guarantee.

Information Concerning the Guarantee Trustee

Each guarantee trustee, other than during the occurrence and continuance of a guarantee event of default, undertakes to perform only such duties as are specifically set forth in the applicable guarantee and, upon a guarantee event of default, must exercise the rights and powers vested in it by the applicable guarantee and use the same degree of care and skill in the exercise thereof as a prudent person would exercise or use in the conduct of his or her own affairs. Subject to this provision, each guarantee trustee is under no obligation to exercise any of the powers vested in it by any guarantee at the request of any holder of preferred trust securities of the applicable Trust unless it is offered reasonable indemnity against the costs, expenses and liabilities that might be incurred thereby.

Termination of a Guarantee

Each guarantee will terminate and be of no further force and effect upon full payment of the redemption price or liquidation distribution for the related preferred trust securities or upon distribution of the related trust debt securities to the holders of the related preferred trust securities. That guarantee will continue to be effective or will be reinstated, as the case may be, if at any time any holder of the related preferred trust securities must restore payment of any sums paid under those preferred trust securities or the guarantee.

Governing Law

Each preferred securities guarantee will be governed by and construed in accordance with the laws of the State of New Jersey.

RELATIONSHIP AMONG THE PREFERRED TRUST SECURITIES, THE TRUST DEBT SECURITIES AND THE PREFERRED SECURITIES GUARANTEE

Payments of distributions and redemption and liquidation payments due on the preferred trust securities of a Trust (to the extent that Trust has funds available for such payments) will be guaranteed by us as set forth under "Description of the Preferred Securities Guarantee." No single document executed by us in connection with the issuance of the preferred trust securities of a Trust will provide for our full, irrevocable and unconditional guarantee of those preferred trust securities. It is only the combined operation of our obligations under the applicable guarantee, the applicable Trust Agreement, the related trust debt securities and the Trust Debt Indenture that has the effect of providing a full, irrevocable and unconditional guarantee of that Trust's obligations under its preferred trust securities. As used in this portion of the prospectus, the term "trust debt securities" refers to the debt securities that will comprise the assets of the Trust.

A holder of any preferred trust security of a Trust may institute a legal proceeding directly against us to enforce the applicable property trustee's rights under the related Trust Agreement, Trust Debt Indenture or guarantee without first instituting a legal proceeding against that property trustee, the trustee under the Trust Debt Indenture or the applicable guarantee trustee, the applicable Trust or any other person or entity if that trustee fails to enforce that particular holder's rights thereunder. Notwithstanding the foregoing, if a Trust Agreement event of default attributable to our failure to pay principal of or premium, if any, or interest on the trust debt securities of a Trust has occurred and is continuing, then each holder of those preferred trust securities may institute a legal proceeding directly against us for enforcement of any such payment to such holder, all as provided in the applicable Trust Debt Indenture.

As long as we make payments of interest and other payments when due on the related trust debt securities, those payments will be sufficient to cover the payment of distributions and redemption and liquidation distributions due on the preferred trust securities of a Trust, primarily because

- the aggregate principal amount of the trust debt securities will be equal to the sum of the aggregate liquidation amount of the related preferred trust securities and common trust securities,

- the interest rate and interest and other payment dates of the trust debt securities will match the distribution rate and distribution and other payment dates for the related preferred trust securities,

- each Trust Agreement provides that we will pay for all and any costs, expenses and liabilities of that Trust except that Trust's obligations under its preferred trust securities and common trust securities, and

- each Trust Agreement provides that the applicable Trust will not engage in any activity that is not consistent with its limited purposes.

If and to the extent that we do not make payments on the trust debt securities comprising the assets of a Trust, that Trust will not have funds available to make payments of distributions or other amounts due on its preferred trust securities.

A principal difference between the rights of a holder of a preferred trust security of a Trust (which represents an undivided beneficial interest in the assets of that Trust) and a holder of a trust debt security is that a holder of a trust debt security will accrue, and (subject to the permissible extension of the interest payment period) is entitled to receive, interest on the principal amount of trust debt securities held, while a holder of preferred trust securities of a Trust is entitled to receive distributions only if and to the extent the applicable Trust has funds available for the payment of those distributions.

Upon any voluntary or involuntary dissolution or liquidation of a Trust not involving a redemption or distribution of any trust debt security, after satisfaction of liabilities to creditors of that Trust, the holders of its preferred trust securities will be entitled to receive, out of assets held by the Trust, the liquidation distribution in cash. See "Description of the Preferred Trust Securities -- Liquidation Distribution upon Dissolution". Upon our voluntary liquidation or bankruptcy, each Trust, as holder of the trust debt securities, would be a creditor of ours, subordinated in the case of junior subordinated trust debt securities described under "Description of Trust Debt Securities," in right of payment to all Senior Indebtedness, but entitled to receive payment in full of principal, premium, if any, and interest, before any of our stockholders receive payments or distributions.

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A default or event of default under any Senior Indebtedness would not constitute an event of default with respect to junior subordinated trust debt securities under the Trust Debt Indenture. However, in the event of payment defaults under, or acceleration of, Senior Indebtedness, the subordination provisions of the junior subordinated trust debt securities provide that no payments may be made in respect of the junior subordinated trust debt securities until the Senior Indebtedness has been paid in full or any payment default thereunder has been cured or waived. Failure to make required payments on the junior subordinated trust debt securities would constitute an event of default.

We and each Trust believe that the above mechanisms and obligations, taken together, are the equivalent of a full and unconditional guarantee by us of payments due in respect of the preferred trust securities of each Trust.

DESCRIPTION OF THE CAPITAL STOCK

The following description summarizes the material terms of our capital stock. Because this section is a summary, it does not describe every aspect of our common stock. For additional information, you should refer to the applicable provisions of the New Jersey Business Corporation Act and our Certificate of Incorporation, as amended (the "Charter") and By-Laws. Our Charter and By-Laws are exhibits to the registration statement of which this prospectus is a part.

Authorized Capital

Our authorized capital stock consists of 500,000,000 shares of common stock, without par value, and 50,000,000 shares of preferred stock, without par value.

Common Stock

General. As of October 31, 2002, 207,420,959 shares of our common stock were issued and outstanding. On November 18, 2002, we issued 17,250,000 additional shares of our common stock pursuant to an underwritten public offering. The outstanding shares of our common stock are, and any common stock offered hereby when issued and paid for will be, fully paid and non-assessable.

Dividend Rights. Holders of our common stock are entitled to such dividends as may be declared from time to time by our board of directors from legally available funds after payment of all amounts owed on any preferred stock that may be outstanding.

Voting Rights. Holders of our common stock are entitled to one vote for each share held by them on all matters presented to shareholders. In the election of directors, shareholders have cumulative voting rights.

Liquidation Rights. After satisfaction of the preferential liquidation rights of any preferred stock, the holders of our common stock are entitled to share, ratably, in the distribution of all remaining net assets.

Preemptive Conversion or Redemption Rights. The holders of our common stock have preemptive rights as to additional issues of our common stock not issued on a competitive basis or by an offering to or through underwriters. The shares of our common stock are not subject to redemption or to any further calls or assessments and are not entitled to the benefit of any sinking fund provisions.

Transfer Agents and Registrars

The co-transfer agents and co-registrars for our common and preferred stock are the Shareholder Services Department of Services and the Continental Stock Transfer and Trust Company.

Preferred Stock

Our board of directors is authorized, without further shareholder action, to divide the preferred stock into one or more classes or series and to determine the designations, preferences, limitations and special rights of any class or series including, but not limited to, the following:

- o the rate of dividend, if any;
- o the rights, if any, of the holders of shares of the series upon our voluntary or involuntary liquidation, dissolution or winding-up;

- the terms and conditions upon which shares may be converted into shares of other series or other capital stock, if issued with the privilege of conversion;

- the price at and the terms and conditions upon which shares may be redeemed; and

- the voting rights, if any.

No shares of preferred stock have been issued.

DESCRIPTION OF THE STOCK PURCHASE CONTRACTS AND STOCK PURCHASE UNITS

We may issue stock purchase contracts representing contracts obligating holders to purchase from us, and us to sell to the holders, a specified number of shares of our common stock (or a range of numbers of shares pursuant to a predetermined formula) at a future date or dates. The price per share of our common stock and number of shares of our common stock may be fixed at the time the stock purchase contracts are issued or may be determined by reference to a specific formula set forth in the stock purchase contracts.

The stock purchase contracts may be issued separately or as a part of units, known as stock purchase units, consisting of (1) a stock purchase contract or (2) a stock purchase contract and our debt securities, preferred trust securities or debt obligations of third parties (including United States Treasury securities), that would secure the holders' obligations to purchase our common stock under the stock purchase contract. The stock purchase contracts may require us to make periodic payments to the holders of the stock purchase units or vice-versa. These payments may be unsecured or prefunded on some basis. The stock purchase contracts may require holders to secure their obligations in a specified manner and in certain circumstances we may deliver newly issued prepaid stock purchase contracts, often known as prepaid securities, upon release to a holder of any collateral securing the holder's obligations under the original stock purchase contract.

The applicable prospectus supplement will describe the terms of any stock purchase contracts or stock purchase units and, if applicable, debt securities or preferred trust securities and will contain a discussion of the material United States federal income tax considerations applicable to the stock purchase contracts and stock purchase units. The description in the applicable prospectus supplement will not contain all of the information you may find useful, and reference will be made to the stock purchase contracts, and, if applicable, collateral or depositary arrangements, relating to the stock purchase contracts or stock purchase units.

PLAN OF DISTRIBUTION

The several Trusts and we may sell the securities directly to purchasers or indirectly through underwriters, dealers or agents. The names of any such underwriters, dealers or agents will be set forth in the relevant prospectus supplement. We may determine the price or other terms of the securities offered under this prospectus by use of an electronic auction. We will describe how any auction will determine the price or any other terms, how potential investors may participate in the auction and the nature of the underwriters' obligations in the related supplement to this prospectus. We will also set forth in the relevant prospectus supplement:

- the terms of the offering of the securities;

- the proceeds we will receive from the offering;

- any underwriting discounts and other items constituting underwriters' compensation;

- any initial public offering price;

- any discounts or concessions allowed or reallowed or paid to dealers; and

- any securities exchanges on which we may list the securities.

The several Trusts and we may distribute the securities from time to time in one or more transactions at:

- a fixed price;

- prices that may be changed;

- market prices at the time of sale;

- prices related to prevailing market prices; or

- negotiated prices.

We will describe the method of distribution in the relevant prospectus supplement.

If we use underwriters with respect to an offering of the securities, we will set forth in the relevant prospectus supplement:

- the name of the managing underwriter, if any;

- the name of any other underwriters; and

- the terms of the transaction, including any underwriting discounts and other items constituting compensation of the underwriters and dealers, if any.

The underwriters will acquire any securities for their own accounts and they may resell the securities from time to time in one or more transactions, including negotiated transactions, at a fixed public offering price and at varying prices determined at the time of sale.

Any initial public offering price and any discounts or concessions allowed or reallowed or paid to dealers may be changed from time to time. We anticipate that any underwriting agreement pertaining to any securities will:

- entitle the underwriters to indemnification by us against certain civil liabilities, including liabilities under the Securities Act, or to contribution with respect to payments that the underwriters may be required to make related to any such civil liability;

- subject the obligations of the underwriters to certain conditions precedent; and

- obligate the underwriters to purchase all securities offered in a particular offering if any such securities are purchased.

If we use a dealer in an offering of the securities, we will sell such securities to the dealer, as principal. The dealer may then resell the securities to the public at varying prices to be determined by such dealer at the time of resale. We will set forth the name of the dealer and the terms of the transaction in the prospectus supplement.

If we use an agent in an offering of the securities, we will name the agent and describe the terms of the agency in the relevant prospectus supplement. Unless we indicate otherwise in the prospectus supplement, we will require an agent to act on a best efforts basis for the period of its appointment.

Dealers and agents named in a prospectus supplement may be considered underwriters of the securities described in the prospectus supplement under the Securities Act. We may indemnify them against certain civil liabilities under the Securities Act.

In the ordinary course of business, we may engage in transactions with underwriters, dealers, agents and their affiliates and they may perform services for us.

The several Trusts and we may solicit offers to purchase the securities and make sales directly to institutional investors or others who may be considered underwriters under the Securities Act with respect to such sales. We will describe the terms of any such offer in the relevant prospectus supplement.

If we authorize underwriters or other agents to solicit offers to purchase the securities from institutional investors pursuant to contracts providing for payment and delivery at a future date, we will indicate that we are doing so in the relevant prospectus supplement. We must approve all purchasers under such contracts; the institutional investors may include commercial and savings banks, insurance companies, pension funds, investment companies, educational and charitable institutions and others.

We will not subject the obligations of such purchasers to any conditions except that:

o we will not allow such purchases if they violate the laws of any jurisdiction to which a proposed purchaser is subject; and

o if we are also selling the securities to underwriters, we will not sell to the underwriters subject to delayed delivery.

Underwriters and other agents will not be responsible for the validity or performance of such contracts providing for payment and delivery at a future date.

We will set forth in the relevant prospectus supplement the anticipated delivery date of the securities and the prospectus delivery obligations of dealers.

Each series of securities will be a new issue and, except for the Common Stock, which is listed on the New York Stock Exchange, will have no established trading market. We may elect to list any series of new securities on an exchange, or in the case of the Common Stock, on any additional exchange, but unless we advise you differently in the prospectus supplement, we have no obligation to cause any securities to be so listed. Any underwriters that purchase securities for public offering and sale may make a market in the securities, but such underwriters will not be obligated to do so and may discontinue any market making at any time without notice. We make no assurance as to the liquidity of, or the trading markets for, any securities.

LEGAL MATTERS

The validity of the securities, including the binding nature of debt securities, to be issued by us will be passed upon for us by R. Edwin Selover, Esquire, our Senior Vice President and General Counsel or James T. Foran, Esquire, our Associate General Counsel and/or such other counsel as is indicated in the applicable prospectus supplement.

Certain matters of Delaware law relating to the validity of the preferred trust securities of the Trusts, the enforceability of the respective trust agreements and the creation of the Trusts will be passed upon by Richards, Layton & Finger, P.A., Wilmington, Delaware, special Delaware counsel to the Trusts. The validity of any offered securities may be passed on for any underwriters, dealers or agents by Sidley Austin Brown & Wood LLP, New York, New York, who may rely on the opinion of Mr. Selover or Mr. Foran as to matters of New Jersey law.

EXPERTS

The financial statements as of December 31, 2001 and 2000 and for each of the three years in the period ended December 31, 2001 and the related financial statement schedule incorporated in this prospectus by reference from our Current Report on Form 8-K dated November 22, 2002, have been audited by Deloitte & Touche LLP, independent auditors, as stated in their report, which is incorporated herein by reference, and have been so incorporated in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and special reports, proxy statements and other information with the SEC. You may read and copy any document that we file at the Public Reference Room of the SEC at 450 Fifth Street, N.W., Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. You may also obtain our filings on the Internet at the SEC's home page at http://www.sec.gov. Our common stock is listed on the New York Stock Exchange under the ticker symbol "PEG." You can obtain information about us at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005.

This prospectus is part of a registration statement on Form S-3 filed with the SEC under the Securities Act of 1933. It does not contain all of the information that is important to you. You should read the registration statement for further information with respect to the securities, the Trust and us. Statements contained in this prospectus concerning the provisions of any document filed as an exhibit to the registration statement or otherwise filed with the SEC highlight selected information, and in each instance reference is made to the copy of the full document as filed with the SEC.

INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE

The SEC allows us to "incorporate by reference" information that we file with it, which means that we can disclose important information to you by referring you to those documents. The information incorporated by reference or deemed incorporated by reference is an important part of this prospectus, and information that we file later with the SEC will be deemed to automatically update and supersede this incorporated information. We incorporate by reference the documents in File No. 9120 listed below and any future filings made with the SEC under Sections 13(a), 13(c), 14, or 15(d) of the Securities Exchange Act of 1934, as amended, prior to the termination of any particular offering of securities hereunder.

- Our Annual Report on Form 10-K for the year ended December 31, 2001;
- Our Amended Quarterly Report on Form 10-Q/A for the quarter ended March 31, 2002;
- Our Quarterly Reports on Form 10-Q for the quarters ended June 30, 2002 and September 30, 2002;
- Our Current Reports on Form 8-K filed with the SEC on January 25, 2002, February 7, 2002, April 16, 2002, July 30, 2002, September 10, 2002, October 11, 2002 and November 22, 2002; and
- Our Amended Current Report on Form 8-K/A dated July 29, 2002.

You can get a free copy of any of the documents incorporated by reference by making an oral or written request directed to:

J. Brian Smith
Director, Investor Relations
PSEG Services Corporation
80 Park Plaza, 6th Floor
Newark, NJ 07101
Telephone (973) 430-6564

You should rely only on the information contained or incorporated by reference or deemed to be incorporated by reference in this prospectus or in a related prospectus supplement. We have not authorized anyone else to provide you with different or additional information. You should not rely on any other information or representations. Our affairs may change after this prospectus and any related prospectus supplement are distributed. You should not assume that the information in this prospectus and any related prospectus supplement is accurate as of any date other than the dates on the front of those documents. You should read all information supplementing this prospectus.

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621

3,565

4,447

Balances at central banks

96,566

5

96,571

1

1

Total financial assets

430,495

26,977

11,283

468,755

262

621
3,565
4,448

For the notes to this table refer to the following page.

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Capital and risk management

Credit risk **Banking activities** continued

Segmental loans and impairment metrics (audited) (restated: see Note 4 for details)

The table below summarises gross loans and ECL provisions coverage, by days past due, by segment and stage, within the scope of the ECL framework.

	ECL provisions coverage							ECL	
		Stage 2 (2,3)					Total		Amounts
	Stage 1	<30 DPD	>30 DPD	Total	Stage 3	Total	charge	Loss rate	written-off
31 December 2018 (1)	%	%	%	%	%	%	£m	basis points	£m
UK PB	0.07	3.05	6.62	3.25	31.29	0.75	339	22.6	445
Ulster Bank RoI	0.20	5.23	9.82	5.48	27.64	3.54	15	6.8	372
Personal (4)	*0.12*	*5.40*	*10.48*	*5.76*	*24.62*	*4.27*	*20*	*13.6*	*343*
Wholesale	*0.33*	*4.88*		*4.82*	*69.68*	*2.12*	*(5)*	*(6.6)*	*29*
Commercial Banking	0.14	2.05	1.86	2.04	38.48	1.22	147	14.3	572
Private Banking	0.09	1.32	3.31	1.88	8.89	0.30	(6)	(4.1)	7
Personal	*0.05*	*1.64*		*1.44*	*8.37*	*0.22*	*(6)*	*(5.4)*	*5*
Wholesale	*0.27*	*1.02*	*3.97*	*2.17*	*13.64*	*0.55*			*2*
RBS International	0.04	1.09		1.04	16.83	0.19	(2)	(1.5)	9
NatWest Markets	0.07	2.95		2.95	14.56	1.33	(92)	(98.6)	89
Central items and other							(3)	(4.3)	
Total loans excluding balances at central banks	0.10	2.80	5.02	2.92	30.06	1.05	398	12.5	1,494
Personal	*0.08*	*3.25*	*6.82*	*3.45*	*26.61*	*1.00*	*354*	*19.8*	*776*
Wholesale	*0.13*	*2.21*	*2.29*	*2.21*	*34.51*	*1.11*	*44*	*3.1*	*718*
Total loans	0.08	2.80	5.02	2.92	30.06	0.83	398	9.8	1,494

	ECL provisions coverage					
		Stage 2 (2,3)				
	Stage 1	<30 DPD	>30 DPD	Total	Stage 3	Total
1 January 2018 (1)	%	%	%	%	%	%
Personal	0.09	2.54	4.80	2.63	28.46	1.31
- UK mortgages	*0.01*	*0.56*	*1.62*	*0.61*	*11.23*	*0.18*
- RoI mortgages	*0.07*	*4.44*	*7.09*	*4.67*	*26.02*	*6.18*
- Credit cards	*1.71*	*9.11*	*27.27*	*9.31*	*53.57*	*5.23*
- Other	*0.80*	*7.99*	*19.64*	*8.30*	*59.44*	*8.03*
Wholesale	0.07	1.88	2.07	1.88	35.51	1.09
- Property	*0.07*	*1.13*	*1.15*	*1.13*	*32.43*	*1.81*
- Corporate	*0.14*	*1.90*	*2.86*	*1.92*	*36.50*	*1.80*
- Financial institutions	*0.03*	*3.57*		*3.38*	*65.71*	*0.34*
- Other	*0.01*	*0.85*		*0.85*		*0.01*
Total financial assets	0.06	2.25	3.75	2.30	31.60	0.95

Notes:

(1) The segment analysis tables at 31 December 2018 include all loans amortised cost within the scope of IFRS 9. The comparative tables at 1 January 2018 include all financial assets within the scope of IFRS 9, including debt securities of £50.4 billion, of which £42.7 billion related to debt securities classified as FVOCI. ECL on these debt securities at 1 January 2018 was £28 million, of which £4 million related to those classified as FVOCI.

(2) 30 DPD 30 days past due, the mandatory 30 days past due backstop is prescribed by IFRS 9 for significant increase in credit risk.

(3) ECL provisions on contingent liabilities and commitments are included within the Financial assets section so as not to distort ECL coverage ratios.

(4) 31 December 2018, £3 million of the write offs related to business banking portfolio in Ulster Bank RoI.

Key points

- The UK PB and Ulster Bank RoI franchises accounted for the vast majority of Personal provisions. In Ulster Bank RoI, Personal provisions were primarily driven by Stage 3 impairments on the legacy mortgage book.

- The Commercial Banking business accounted for the majority of Wholesale exposures. Wholesale provisions in UK PB reflected exposures to business banking customers and also the commercial businesses in RBS England & Wales/NatWest Scotland.

- On performing exposures (Stage 1 and Stage 2), materially higher ECL provision was held in credit deteriorated Stage 2 exposures than in Stage 1, in line with expectations. This was also reflected in provision coverage levels.

- Also in line with expectations, the majority of Stage 2 exposures were less than 30 days past due, since PD deterioration is the primary driver of credit deterioration.

- The differing cover rates between the Personal and Wholesale portfolios and across the business largely reflected differences in asset mix, including security cover, and the differing impacts of external environment events.

Capital and risk management

Credit risk **Banking activities** continued

Portfolio summary **sector analysis** (audited)

The table below summarises financial assets and off-balance sheet exposures gross of ECL and related ECL provisions, impairment and past due by sector, asset quality and geographical region based on the country of operation of the customer.

	Personal				Wholesale					Total
	Mortgages (1)	Credit cards	Other personal	Total	Property	Corporate	FI	Sovereign	Total	
31 December 2018	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Loans by geography	165,081	4,216	9,578	178,875	36,707	72,240	25,011	6,967	140,925	319,800
- UK	150,233	4,112	9,117	163,462	33,855	60,657	11,611	3,089	109,212	272,674
- RoI	14,350	104	233	14,687	1,114	3,733	392	2,497	7,736	22,423
- Other Europe	102		67	169	1,395	3,760	5,903	1,088	12,146	12,315
- RoW	396		161	557	343	4,090	7,105	293	11,831	12,388
Loans by asset quality (2,3)	165,081	4,216	9,578	178,875	36,707	72,240	25,011	6,967	140,925	319,800
- AQ1-AQ4	104,989	35	1,040	106,064	16,133	22,587	22,397	6,802	67,919	173,983
- AQ5-AQ8	55,139	3,990	7,736	66,865	18,815	47,651	2,574	161	69,201	136,066
- AQ9	1,287	69	239	1,595	74	359	5		438	2,033
- AQ10	3,666	122	563	4,351	1,685	1,643	35	4	3,367	7,718
Loans by stage	165,081	4,216	9,578	178,875	36,707	72,240	25,011	6,967	140,925	319,800
- Stage 1	149,760	2,851	6,942	159,553	33,145	61,844	24,502	6,941	126,432	285,985
- Stage 2	11,655	1,243	2,073	14,971	1,877	8,753	474	22	11,126	26,097
- Stage 3	3,666	122	563	4,351	1,685	1,643	35	4	3,367	7,718
Loans - past due analysis (4,5)	165,081	4,216	9,578	178,875	36,707	72,240	25,011	6,967	140,925	319,800
- Not past due	160,165	4,027	8,749	172,941	35,420	69,782	24,388	6,923	136,513	309,454
- Past due 1-29 days	1,714	69	180	1,963	270	1,397	604	42	2,313	4,276
- Past due 30-89 days	1,048	40	105	1,193	271	344	11	2	628	1,821
- Past due 90-180 days	632	29	69	730	56	83	1		140	870
- Past due >180 days	1,522	51	475	2,048	690	634	7		1,331	3,379
Loans - Stage 2	11,655	1,243	2,073	14,971	1,877	8,753	474	22	11,126	26,097
- Not past due	9,788	1,172	1,843	12,803	1,556	8,196	472	22	10,246	23,049
- Past due 1-29 days	1,126	43	133	1,302	68	244	1		313	1,615
- Past due 30-89 days	741	28	97	866	253	313	1		567	1,433
Weighted average life *										
- ECL measurement (years)	8	2	3	5	3	3	4	3	3	4
Weighted average 12 months PDs *										
- IFRS 9 (%)	0.32	4.03	2.77	0.54	0.75	0.97	0.14	0.06	0.75	0.62
- Basel (%)	0.84	3.52	3.50	1.04	0.95	1.43	0.23	0.06	1.01	1.03
ECL provisions by geography	839	230	728	1,797	588	941	41	1	1,571	3,368
- UK	237	227	707	1,171	518	615	27	1	1,161	2,332
- RoI	602	3	21	626	43	125	2		170	796
- Other Europe					22	53	10		85	85

- RoW					*5*	*148*	*2*		*155*	*155*
ECL provisions by stage	839	230	728	1,797	588	941	41	1	1,571	3,368
- Stage 1	*23*	*38*	*61*	*122*	*43*	*107*	*12*	*1*	*163*	*285*
- Stage 2	*150*	*120*	*247*	*517*	*39*	*200*	*7*		*246*	*763*
- Stage 3	*666*	*72*	*420*	*1,158*	*506*	*634*	*22*		*1,162*	*2,320*
ECL provisions coverage (%)	0.51	5.46	7.60	1.00	1.60	1.30	0.16	0.01	1.11	1.05
- Stage 1 (%)	*0.02*	*1.33*	*0.88*	*0.08*	*0.13*	*0.17*	*0.05*	*0.01*	*0.13*	*0.10*
- Stage 2 (%)	*1.29*	*9.65*	*11.92*	*3.45*	*2.08*	*2.28*	*1.48*		*2.21*	*2.92*
- Stage 3 (%)	*18.17*	*59.02*	*74.60*	*26.61*	*30.03*	*38.59*	*62.86*		*34.51*	*30.06*
ECL charge	57	87	210	354	30	13	3	(2)	44	398
- UK	*38*	*88*	*207*	*333*	*31*	*9*	*6*	*(2)*	*44*	*377*
- RoI	*19*	*(1)*	*3*	*21*	*(1)*	*(3)*	*(1)*		*(5)*	*16*
- Other Europe						*8*	*(2)*		*6*	*6*
- RoW						*(1)*			*(1)*	*(1)*
ECL loss rate (%)	0.03	2.06	2.19	0.20	0.08	0.02	0.01	(0.03)	0.03	0.12
Amounts written-off	368	79	329	776	292	395	31		718	1,494

* Not within audit scope.

For the notes to this table refer to the following page.

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Capital and risk management

Credit risk Banking activities continued

Portfolio summary sector analysis (audited)

	Personal				Wholesale							
		Credit	Other									
	Mortgages	cards	personal	Total	Property	Corporate	FI	Sovereign	Total	Total	Fixed	Variable
31 December 2018	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Loans by residual maturity	165,081	4,216	9,578	178,875	36,707	72,240	25,011	6,967	140,925	319,800	152,557	167,243
- <1yr	*11,244*	*919*	*4,960*	*17,123*	*9,533*	*29,788*	*17,602*	*6,362*	*63,285*	*80,408*	*20,534*	*59,874*
- 1-5yr	*35,184*	*3,297*	*3,816*	*42,297*	*18,797*	*30,772*	*6,167*	*245*	*55,981*	*98,278*	*34,250*	*64,028*
- 5yr	*118,653*		*802*	*119,455*	*8,377*	*11,680*	*1,242*	*360*	*21,659*	*141,114*	*97,773*	*43,341*
Other financial assets by asset quality (2)					105	652	8,838	134,546	144,141	144,141		
- AQ1-AQ4					*105*	*10*	*8,110*	*134,546*	*142,771*	*142,771*		
- AQ5-AQ8						*642*	*721*		*1,363*	*1,363*		
- AQ9							*4*		*4*	*4*		
- AQ10							*3*		*3*	*3*		
Off-balance sheet	13,228	16,613	12,229	42,070	16,044	52,730	28,761	29,277	126,812	168,882		
- Loan commitments	*13,228*	*16,613*	*12,229*	*42,070*	*15,335*	*48,569*	*26,684*	*29,276*	*119,864*	*161,934*		
- Financial guarantees					*709*	*4,161*	*2,077*	*1*	*6,948*	*6,948*		
Off-balance sheet by asset quality (2)	13,228	16,613	12,229	42,070	16,044	52,730	28,761	29,277	126,812	168,882		
- AQ1-AQ4	*12,116*	*422*	*9,103*	*21,641*	*11,945*	*36,134*	*27,364*	*29,262*	*104,705*	*126,346*		
- AQ5-AQ8	*1,101*	*15,900*	*3,116*	*20,117*	*3,928*	*16,390*	*1,397*	*15*	*21,730*	*41,847*		
- AQ9	*1*	*8*	*10*	*19*	*6*	*46*			*52*	*71*		
- AQ10	*10*	*283*		*293*	*165*	*160*			*325*	*618*		

		Total IFRS 9 credit risk exposure by stage					
	Total credit		Stage 2 (2,3)				ECL
	exposure	Stage 1	<30 DPD	>30 DPD	Total	Stage 3	provisions
1 January 2018	£m	£m	£m	£m	£m	£m	£m
Personal	177,196	155,843	14,460	625	15,085	6,268	2,316
UK mortgages	*146,556*	*134,350*	*10,119*	*431*	*10,550*	*1,656*	*262*
RoI mortgages	*15,549*	*10,674*	*1,351*	*127*	*1,478*	*3,397*	*961*
Credit cards	*4,247*	*3,097*	*999*	*11*	*1,010*	*140*	*222*
Other personal (6)	*10,844*	*7,722*	*1,991*	*56*	*2,047*	*1,075*	*871*
Wholesale	194,988	178,086	11,500	387	11,887	5,015	2,131
Property	*37,877*	*33,884*	*1,942*	*87*	*2,029*	*1,964*	*685*

Corporate	*73,667*	*62,253*	*8,224*	*245*	*8,469*	*2,945*	*1,325*
Financial institutions	*34,064*	*32,923*	*981*	*55*	*1,036*	*105*	*115*
Sovereign	*49,380*	*49,026*	*353*		*353*	*1*	*6*
Total financial assets excluding balances at central banks	372,184	333,929	25,960	1,012	26,972	11,283	4,447
Balances at central banks	96,571	96,566	5		5		1
Total financial assets	468,755	430,495	25,965	1,012	26,977	11,283	4,448
Total contingent liabilities and commitments	146,800	139,550	6,388	113	6,501	749	
Total exposure	615,555	570,045	32,353	1,125	33,478	12,032	
Financial assets - asset quality (2)							
- AQ1-AQ4	230,773	223,789	6,883	101	6,984		
- AQ5-AQ8	128,814	109,962	17,449	660	18,109	743	
- AQ9	2,912	178	1,628	251	1,879	855	
- AQ10 (3)	9,685					9,685	

Notes:

(1) At 31 December 2018, Mortgages include £0.7 billion secured lending in Private Banking, in line with ECL calculation methodology.

(2) AQ bandings are based on Basel PDs.

(3) At 31 December 2018, AQ10 includes £0.6 billion (31 December 2017 £0.7 billion) RoI mortgages which are not currently considered defaulted for capital calculation purposes for RoI but included in Stage 3.

(4) 30 DPD 30 days past due, the mandatory 30 days past due backstop as prescribed by the IFRS 9 guidance for significant increase in credit risk.

(5) Days past due Personal products: at a high level, for amortising products, the number of days past due is derived from the arrears amount outstanding and the monthly repayment instalment. For credit cards, it is based on payments missed, and for current accounts the number of continual days in excess of borrowing limit. Wholesale products: the number of days past due for all products is the number of continual days in excess of borrowing limit.

(6) At 1 January 2018, mortgages other than UK and RoI were reported within other personal but at 31 December 2018 they are reported separately.

Capital and risk management

Credit risk Banking activities continued

Portfolio summary sector analysis (audited)

Wholesale forbearance

The table below summarises Wholesale forbearance, Heightened Monitoring and Risk of Credit Loss by sector. Personal forbearance is disclosed on page 144.

2018	FI £m	Property £m	Sovereigns £m	Other corporate £m	Total £m
Forbearance (flow)	14	305		2,247	2,566
Forbearance (stock)	15	477		2,756	3,248
Heightened Monitoring and Risk of Credit Loss	100	503	16	4,145	4,764
2017					
Forbearance (flow)	11	417		1,473	1,901
Forbearance (stock)	14	764		3,067	3,845
Heightened Monitoring and Risk of Credit Loss	144	739		4,183	5,066

Risk elements in lending (restated: see Note 4 for details)

The table below summarises risk elements in lending by segment on an IAS 39 basis.

	UK PB £m	Ulster Bank RoI £m	Commercial Banking £m	Private Banking £m	RBS International £m	NatWest Markets £m	Central items & other £m	Total £m
At 1 January 2017	1,975	3,513	2,343	105	109	2,264	1	10,310
Inter segment transfers	(163)		1,547			(1,384)		
Currency translation and other adjustments		123			5	(86)	1	43
Additions	945	550	1,872	28	62	98	14	3,569
Transfers between REIL and potential problem loans	(153)		11	(2)	7	8		(129)
Transfer to performing book	(263)	(336)	(314)		(33)	(12)	(1)	(959)
Repayments and disposals	(373)	(444)	(1,349)	(32)	(41)	(468)	(13)	(2,720)
Amounts written-off	(425)	(124)	(482)	(4)	(6)	(167)	(2)	(1,210)
At 31 December 2017	1,543	3,282	3,628	95	103	253		8,904

Provisions (restated: see Note 4 for details)

The table below summarises provisions by segment on an IAS 39 basis.

	UK PB	Ulster Bank RoI	Commercial Banking	Private Banking	RBS International	NatWest Markets	Central items & other	Total

	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January 2017	1,230	1,200	1,152	31	38	803	1	4,455
Inter segment transfers	(110)		403			(293)		
Currency translation and other adjustments		8	(7)			(27)		(26)
Repayments and disposals						(5)		(5)
Amounts written-off	(424)	(124)	(483)	(4)	(6)	(167)	(2)	(1,210)
Recoveries of amounts previously written-off	114	12	19		1	10		156
Charges/(releases) to income statement	207	60	390	6	3	(137)	1	530
Unwind of discount	(31)	(25)	(18)	(1)	(1)	(10)		(86)
At 31 December 2017	986	1,131	1,456	32	35	174		3,814

Capital and risk management

Credit risk Banking activities continued

Portfolio summary sector analysis (audited)

Key points

- Geography The majority of exposures in both the Personal and Wholesale portfolios were in the UK and the Republic of Ireland. Other exposures in Europe and the Rest of the World were mainly Wholesale. Mortgages, the vast majority of which are in the UK, accounted for more than half of the total exposure.

- Asset quality Measured against RBS s asset quality scale, 54% of lending exposure was rated in the AQ1-AQ4 bands at 31 December 2018. This equated to an indicative investment rating of BBB- or above. Specifically 59% of Personal and 48% of Wholesale lending exposure were in the AQ1-AQ4 category respectively.

- Loans by stage 90% of exposures were in Stage 1, with 8% in Stage 2 significantly credit deteriorated. Stage 3 assets, which align to AQ10, represented 2% of total exposures. In line with expectations, the Personal portfolio had a higher proportion of unsecured lending assets in Stage 2 than the mortgage portfolio. In the Wholesale portfolio, the proportion of assets in Stage 2 was slightly lower than in Personal overall.

- Loans Past due analysis Stage 2: the vast majority of assets overall were not past due, with the Stage 2 classification driven primarily by changes in lifetime PD. (For further detail, refer to the Significant increase in credit risk section). In mortgages, the majority of assets past due by more than 180 days were in Ulster Bank RoI reflecting the legacy mortgage portfolio and the residual effects from the financial crisis. In other personal, the relatively high rate of exposures past due by more than 90 days reflected the fact that impaired assets can be held on balance sheet with commensurate ECL provision for up to six years after default. Similarly in the Wholesale portfolio, impaired assets can be held on the balance sheet for a significant period of time while restructuring and recovery processes are concluded.

- Weighted average 12 months PDs In Wholesale, Basel PDs, which are based on a through-the-cycle approach, tend to be higher than point-in-time best estimate IFRS 9 PDs, reflecting the current state in the economic cycle, and also an element of conservatism in the regulatory capital framework. In Personal, the Basel PDs, which are point-in-time estimates, tend to be higher also reflecting conservatism, higher in mortgages than other products, and an element of default rate under-prediction in the IFRS 9 PD models. This has been mitigated by ECL overlays of approximately £60 million at the year end, pending model calibrations being implemented. The IFRS 9 PD for credit cards was higher than the Basel equivalent and reflected the relative sensitivity of the IFRS 9 model to forward-looking economic drivers.

- ECL provision by geography In line with exposures by geography, the weight of ECL related to exposures in the UK and the Republic of Ireland. The ECL in RoI was mainly Stage 3 provisions in the legacy Ulster Bank RoI mortgage portfolio.

- ECL provision by stage and coverage The weight of ECL by value was in Stage 3 impaired, with similar seen in both Personal and Wholesale. Provision coverage was progressively higher by stage reflecting the lifetime nature of losses in both Stage 2 and Stage 3. In the Personal portfolio, provision coverage was materially lower in mortgages relative to credit cards and other personal reflecting the secured nature of the facilities. For Wholesale exposures, security and enterprise value mitigated against losses in Stage 3.

- The ECL charge for the year was £398 million. This reflected the relatively stable external environment.

- Other financial assets by asset quality Consisting almost entirely of cash and balances at central banks and debt securities, these assets were mainly within the AQ1-AQ4 category.

- Off-balance sheet exposures by asset quality For Personal exposures, undrawn exposures are reflective of available credit lines in credit cards and current accounts. Additionally, the mortgage portfolio had undrawn exposure, where a formal offer has been made to a customer but has not yet been drawn down. There is also a legacy portfolio of flexible mortgages where a customer has the right and ability to draw down further funds. The asset quality distribution in mortgages is heavily weighted to the highest quality bands AQ1-AQ4, with credit card concentrated in the risk bands AQ5-AQ8. In Wholesale, 83% of undrawn exposure, relating mainly to loan commitments, was in the AQ1-AQ4 category.

- Forbearance Completed forbearance flow in 2018 for Wholesale was £2.6 billion compared to £1.9 billion in 2017. Forbearance granted in the transport sector increased to £493 million from £54 million, mainly driven by a customer which has been restructured and moved to Stage 2 from Stage 3 during the year. Forbearance across the diverse services sector increased from £347 million to £763 million. Of the forbearance that completed during the year, £1.1 billion related to payment concessions (2017 £1.4 billion) and £1.4 billion related to non-payment concessions (2017 £0.5 billion). Forbearance stock reduced by £0.6 billion, from £3.8 billion to £3.2 billion, driven by a decrease in forborne exposure in the energy and resources, property and retail and leisure sectors.

- Heightened Monitoring and Risk of Credit Loss Exposure decreased from £5.1 billion at 31 December 2017, to £4.8 billion at 31 December 2018. There was also a decrease in the number of customers classified as Heightened Monitoring and Risk of Credit Loss during the year. Despite the current economic uncertainty in the UK, the portfolio has remained stable.

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Capital and risk management

Credit risk Banking activities continued

Portfolio summary sector analysis (audited)

The table below summarises both current and potential exposure by geographical region on an IAS 39 basis.

		Wholesale (1)					Wholesale (1)				
		Banks and			Current		Banks and				Total
	Personal	other FI s	Sovereigns (2)	Other	exposure	Personal	other FI s	Sovereigns (2)	Other	Total	exposure
2017	£m	£m	£m	£m	£m	%	%	%	%	%	£m
UK	158,965	17,992	91,161	94,896	363,014	33	4	19	20	76	413,378
RoI	15,319	751	2,416	4,612	23,098	3		1	1	5	24,502
Other Western Europe	514	7,504	43,414	8,559	59,991		2	9	2	13	86,866
US	377	6,987	8,430	2,580	18,374		1	2	1	4	31,497
RoW (3)	1,461	4,575	2,155	3,144	11,335		1		1	2	14,602
	176,636	37,809	147,576	113,791	475,812	36	8	31	25	100	570,845

Notes:

(1) Includes SME customers managed in Commercial Banking who are assigned a sector under RBS s sector concentration framework.

(2) Includes exposures to central governments, central banks and sub-sovereigns such as local authorities.

(3) Rest of world (RoW) also includes supranationals such as the World Bank and exposure relating to ocean-going vessels which cannot be meaningfully assigned to specific countries from a country risk perspective.

Loan asset quality

The table below summarises asset quality and impairments by banks and customers on an IAS 39 basis.

	AQ1-AQ4	AQ5-AQ8	AQ9	AQ10	Past due	Impaired	Impairment provision	Total
2017	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Banks	27.7	2.6						30.3
Customers	226.8	109.6	2.8	0.7	6.4	7.4	(3.8)	349.9

Loan sector concentration

The table below summarises gross loans to banks and customers (excluding reverse repos) and related credit metrics by sector, on an IAS 39 basis.

Credit metrics

2017	Gross loans £m	REIL £m	Provisions £m	REIL as a % of gross loans %	Provisions as a % of REIL %	Provisions as a % of gross loans %	Impairment losses/ (releases) £m	Amounts written-off £m
Central and local government	4,684							
Finance	30,832	54	44	0.2	81	0.1	3	7
Personal - mortgage (1)	163,010	3,876	994	2.4	26	0.6	50	87
- unsecured	14,587	937	763	6.4	81	5.2	235	424
Property	33,381	1,119	283	3.4	25	0.8	(82)	133
Construction	3,798	426	298	11.2	70	7.8	196	36
Of which: commercial real estate	*24,784*	*1,189*	*293*	*4.8*	*25*	*1.2*	*(76)*	*139*
Manufacturing	8,862	147	64	1.7	44	0.7	4	25
Finance leases and instalment credit	12,019	170	88	1.4	52	0.7	23	14
Retail, wholesale and repairs	12,300	446	193	3.6	43	1.6	93	81
Transport and storage	4,241	700	195	16.5	28	4.6	(32)	165
Health, education and leisure	11,337	330	145	2.9	44	1.3	65	48
Hotels and restaurants	6,049	193	80	3.2	41	1.3	17	46
Utilities	4,172	35	21	0.8	60	0.5	(18)	13
Other	17,726	471	256	2.7	54	1.4	(10)	131
Latent			390				(14)	
Total customer	326,998	8,904	3,814	2.7	43	1.2	530	1,210
Total banks	16,264							

Note:

(1) Mortgages are reported in sectors other than personal mortgages by certain businesses based on the nature of the relationship with the customer.

Past due analysis

The table below summarises loans amortised cost to customers that were past due at the balance sheet date but were not considered impaired.

Number of days	2017 £m	By sector	2017 £m
Past due 1-29 days	3,535	Personal	3,731
Past due 30-59 days	902	Property and construction	667
Past due 60-89 days	456	Financial institution	24
Past due 90 days or more	1,481	Other corporate	1,952
	6,374		6,374

Capital and risk management

Credit risk Banking activities continued

Credit risk enhancement and mitigation (audited)

The table below summarises exposures of modelled portfolios within the scope of the ECL framework and related credit risk enhancement and mitigation (CREM). Excluded from this analysis are the non modelled portfolios, primarily Private Banking and RBSI mortgage portfolios, which are discussed in the Personal portfolio section, including loan-to-value ratios. Refer to Policy elections and simplifications relating to IFRS 9 section for details on non-modelled portfolios.

	Gross		Maximum credit risk		CREM by type			CREM coverage		Exposure post CREM	
				Stage	Financial		Other		Stage		
	exposure	ECL	Total	3	(1)	Property	(2)	Total	3	Total	Stage 3
2018	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Financial assets											
Cash and balances at central banks	87.2		87.2							87.2	
Loans - amortised cost (3)	302.6	3.2	299.4	5.0	4.1	188.1	19.7	211.9	4.5	87.5	0.5
Personal (4)	164.6	1.7	162.9	2.9		151.7		151.7	2.7	11.2	0.2
Wholesale (5)	138.0	1.5	136.5	2.1	4.1	36.4	19.7	60.2	1.8	76.3	0.3
Debt securities	57.0		57.0							57.0	
Total financial assets	446.8	3.2	443.6	5.0	4.1	188.1	19.7	211.9	4.5	231.7	0.5
Contingent liabilities and commitments											
Personal (6)	31.0		31.0	0.3		4.9		4.9		26.1	0.3
Wholesale	126.2		126.2	0.3	0.6	5.9	6.1	12.6		113.6	0.3
Total off balance sheet	157.2		157.2	0.6	0.6	10.8	6.1	17.5		139.7	0.6
Total exposure	604.0	3.2	600.8	5.6	4.7	198.9	25.8	229.4	4.5	371.4	1.1

Notes:

(1) Financial collateral includes cash and securities collateral.

(2) Other collateral includes guarantees, charges over trade debtors as well as the amount by which credit risk exposure is reduced through netting arrangements, mainly cash management pooling, which give RBS a legal right to set off the financial asset against a financial liability due to the same counterparty.

(3) RBS holds collateral in respect of individual loans amortised cost to banks and customers. This collateral includes mortgages over property (both personal and commercial); charges over business assets such as plant and equipment, inventories and trade debtors; and guarantees of lending from parties other than the borrower. RBS obtains collateral in the form of securities in reverse repurchase agreements. Collateral values are capped at the value of the loan.

(4) On personal, Stage 3 mortgage exposures have relatively limited uncovered exposure reflecting the security held. On unsecured credit cards and other personal borrowing, the residual uncovered amount reflects historical experience of continued cash recovery post default through on-going engagement with customers.

(5) Stage 3 exposures post credit risk enhancement and mitigation in wholesale mainly represent enterprise value and the impact of written down collateral values; an individual assessment to determine ECL will consider multiple scenarios and in some instances allocate a probability weighting to a collateral value in excess of the written down value.

(6) At 31 December 2018, £0.3 billion personal Stage 3 balances primarily relate to loan commitments, the draw down of which is effectively prohibited.

The table below summarises financial asset exposures, both gross and net of offset arrangements, as well as credit mitigation and enhancement.

					Collateral (1)					
2017	Gross exposure £bn	IFRS offset (5) £bn	Carrying value (6) £bn	Balance sheet offset (7) £bn	Cash (2) £bn	Securities (3) £bn	Real estate and other Residential (4) £bn	Commercial (4) £bn	Credit enhancement (8) £bn	Exposure post credit mitigation and enhancement £bn
Cash and balances at central banks	98.4		98.4							98.4
Trading assets	118.6	(32.6)	86.0	(0.3)		(32.5)				53.2
Derivatives	177.9	(17.1)	160.8	(128.3)	(20.3)	(5.9)			(6.3)	
Settlement balances	3.2	(0.7)	2.5							2.5
Loans - amortised cost	334.1	(12.5)	321.6	(27.9)	(0.9)	(11.2)	(174.2)	(45.0)	(2.1)	60.3
Other financial assets	52.0		52.0					(0.1)		51.9
Total third party gross of short positions	784.2	(62.9)	721.3	(156.5)	(21.2)	(49.6)	(174.2)	(45.1)	(8.4)	266.3
Short positions	(28.5)		(28.5)							(28.5)
Net of short positions	755.7	(62.9)	692.8	(156.5)	(21.2)	(49.6)	(174.2)	(45.1)	(8.4)	237.8

Notes:

(1) RBS holds collateral in respect of individual loans. This collateral includes mortgages over property (both personal and commercial); charges over business assets such as plant, inventories and trade debtors; and guarantees of lending from parties other than the borrower. RBS obtains collateral in the form of securities in reverse repurchase agreements. Cash and securities are received as collateral in respect of derivative transactions.

(2) Includes cash collateral pledged by counterparties based on daily mark-to-market movements of net derivative positions with the counterparty.

(3) Represent the fair value of securities received from counterparties, mainly relating to reverse repo transactions as part of netting arrangements.

(4) Property valuations are capped at the loan value and reflect the application of haircuts in line with regulatory rules to indexed valuations. Commercial collateral includes ships and plan and equipment collateral.

(5) Relates to offset arrangements that comply with IFRS criteria and transactions cleared through and novated to central clearing houses, primarily London Clearing House (LCH) and US Government Securities Clearing Corporation. During 2017 changes in the legal contracts with LCH and CME led to many derivatives cleared through that counterparty being settled to market each day rather than being collateralised as previously. This led to the derecognition of the associated assets and liabilities.

(6) The carrying value on the balance sheet represents the maximum exposure to credit risk by class of financial instrument.

(7) The amount by which credit risk exposure is reduced through arrangements, such as master netting agreements and cash management pooling, which give RBS a legal right to set off the financial asset against a financial liability due to the same counterparty.

(8) Comprises credit derivatives (bought protection) and guarantees against exposures.

Capital and risk management

Credit risk **Banking activities** continued

Personal portfolio (audited)

Disclosures in the Personal portfolio section include drawn exposure (gross of provisions). Loan-to-value (LTV) ratios are split by stage under IFRS 9 at 31 December 2018 and by performing and non-performing status under IAS 39 at 31 December 2017.

	2018					2017				
	UK PB	Ulster Bank RoI	Private Banking	RBSI	Total	UK PB	Ulster Bank RoI	Private Banking	RBSI	Total
Personal lending	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Mortgages	138,250	14,361	9,082	2,684	164,377	136,625	15,352	8,421	2,745	163,143
Of which:										
Owner occupied	122,642	13,105	7,953	1,781	145,481	118,764	13,455	7,275	1,821	141,315
Buy-to-let	15,608	1,256	1,129	903	18,896	17,861	1,897	1,146	924	21,828
Interest only - variable	8,358	188	3,871	489	12,906	11,245	260	4,076	636	16,217
Interest only - fixed	12,229	12	3,636	187	16,064	12,584	8	2,866	96	15,554
Mixed (1)	6,036	68	2	18	6,124	6,039	79	2	20	6,140
Impairment provisions (2)	212	602	5	16	835	153	909	7	27	1,096
Other personal lending (3)	11,633	330	1,676	55	13,694	11,080	348	1,701	65	13,194
Impairment provisions (2)	909	25	19	1	954	833	44	19	2	898
Total personal lending	149,883	14,691	10,758	2,739	178,071	147,705	15,700	10,122	2,810	176,337
Mortgage LTV ratios										
- Total portfolio	56%	62%	56%	58%	57%	56%	69%	55%	58%	57%
- Stage 1	56%	58%	56%	57%	56%	56%	65%	55%	56%	57%
- Stage 2	58%	67%	58%	55%	59%					
- Stage 3	55%	77%	58%	99%	69%	57%	88%	59%	122%	78%
- Buy-to-let	53%	64%	53%	53%	54%	54%	75%	54%	50%	56%
- Stage 1	53%	58%	53%	52%	53%					
- Stage 2	57%	72%	53%	57%	60%					
- Stage 3	58%	78%	68%	75%	71%					
Gross new mortgage lending	29,555	1,015	1,846	353	32,769	30,314	890	2,243	481	33,928
of which:										
Owner occupied	28,608	1,004	1,689	241	31,542	28,504	875	1,904	319	31,602
Weighted average LTV	69%	73%	62%	68%	69%	70%	75%	63%	70%	70%
Buy-to-let	947	11	157	112	1,227	1,810	15	339	162	2,326
Weighted average LTV	61%	57%	55%	61%	60%	62%	57%	56%	62%	61%
Interest only - variable rate	43		697	13	753	335	6	902	39	1,282
Interest only - fixed rate	1,189		764	43	1,996	1,835	1	874	48	2,758
Mixed (1)	912	1			913	893				893
Mortgage forbearance (4)										
Forbearance flow	446	210	11		667	440	201	31	5	677
Forbearance stock	1,338	2,645	8		3,991	1,384	3,893	7	25	5,309
Current	*724*	*1,291*	*6*		*2,021*	*834*	*1,779*	*6*	*12*	*2,631*
1-3 months in arrears	*350*	*261*			*611*	*304*	*466*		*2*	*772*
> 3 months in arrears	*264*	*1,093*	*2*		*1,359*	*246*	*1,648*	*1*	*11*	*1,906*

Notes:

(1) Includes accounts which have an interest only sub-account and a capital and interest sub-account to provide a more comprehensive view of interest only exposures.

(2) 31 December 2018 data was prepared under IFRS 9. 31 December 2017 data was prepared under IAS 39. For UK PB this excludes a non-material amount of provisions held on relatively small legacy portfolios.

(3) Excludes loans that are commercial in nature, for example loans guaranteed by a company and commercial real estate lending to Personal customers.

(4) The reduction in RBSI forbearance is due to reclassification.

Capital and risk management

Credit risk Banking activities continued

Key points

- Overall The overall credit risk profile of the Personal portfolio, and its performance against credit risk appetite, remained stable during 2018.

- Total lending Total mortgage lending grew by £1.2 billion with new lending partly offset by redemptions and repayments.

- New mortgage lending was lower than 2017. Existing mortgage stock and new business were closely monitored against agreed risk appetite parameters. These included loan-to-value ratios, buy-to-let concentrations, new-build concentrations and credit quality. Underwriting standards were maintained during the period.

- Owner occupied and buy-to-let Most of the mortgage growth was in the owner-occupied portfolio. New mortgages in the buy-to-let portfolio remained subdued.

- LTVs The mortgage portfolio loan-to-value ratio remained stable. The improvement in Ulster Bank RoI reflected house price recovery and the disposal of a portfolio of mortgages during the year, which also contributed to the reduction in the level of exposures in Stage 3.

- Interest only By value, the proportion of mortgages on interest only and mixed terms (capital and interest only) reduced, driven by fewer buy-to-let mortgages.

- Regional mortgage analysis For UK PB, 42% of mortgage lending was in Greater London and the South East (31 December 2017 43%). The level of exposure in this region remained broadly unchanged, reflecting lower demand for buy-to-let properties as well as mortgage redemptions. The weighted average loan-to-value for these regions was 52% (31 December 2017 51%) compared to an average of 56%.

- Interest rate profile As at 31 December 2018, 81% of customers in the UK PB mortgage portfolio were on fixed rates (42% on five-year deals). In addition, 97% of all new mortgage completions in 2018 were fixed rate mortgages (62% of which were five-year mortgages), as customers sought to minimise the impact of potential rate rises.

- **Provisions** As expected, total ECL including ECL for unsecured lending generally increased under the IFRS 9 methodology compared to provisions calculated under IAS 39. The reduction in Ulster Bank RoI mortgage provisions was driven by a sale of legacy impaired debt.

- **Other lending** Total unsecured lending grew modestly in 2018, driven by growth in the PB personal loan portfolio. Overdraft balances have shown a modest decline year-on-year.

- **Other lending asset quality** Unsecured credit quality remained stable, reflecting active portfolio management. Credit standards and controls were tightened across all three unsecured products to ensure that higher risk customer performance remained within risk appetite.

Personal portfolio (audited)

Mortgage LTV distribution by stage

The table below summarises gross mortgage lending and related ECL by LTV band. Mortgage lending not within the scope of IFRS 9 ECL reflected portfolios carried at fair value.

UK PB	Mortgages						ECL				ECL provisions coverage (2)			
	Stage 1	Stage 2	Stage 3	Not within IFRS 9 ECL scope	Total	Of which: gross new lending	Stage 1	Stage 2	Stage 3	Total (1)	Stage 1	Stage 2	Stage 3	Total
2018	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	%	%	%	%
≤50%	47,111	3,423	516	153	51,203	4,779	2	16	64	82		0.5	12.4	0.2
>50% and ≤70%	44,037	3,632	459	49	48,177	8,535	2	23	39	64		0.6	8.5	0.1
>70% and ≤80%	20,345	1,490	135	15	21,985	7,434	1	11	11	23		0.7	8.1	0.1
>80% and ≤90%	12,733	1,118	81	12	13,944	7,524	2	12	8	22		1.1	10.0	0.2
>90% and ≤100%	2,343	178	24	7	2,552	1,104	1	4	3	8		2.4	12.1	0.3
>100% and ≤110%	57	35	8	1	101			2	1	3	0.1	4.6	14.1	2.8
>110% and ≤130%	53	41	9	2	105			2	1	3	0.1	5.4	14.6	3.4
>130% and ≤150%	23	23	6		52			1	1	2	0.1	6.2	13.4	4.3
>150%	3	9	3		15			1	1	2	0.1	6.2	17.3	7.2
Total with LTVs	126,705	9,949	1,241	239	138,134	29,376	8	72	129	209		0.7	10.4	0.2
Other	96	13	4	3	116	179		1	2	3		4.7	53.5	2.6
Total	126,801	9,962	1,245	242	138,250	29,555	8	73	131	212		0.7	10.5	0.2

2017	Performing £m	Non-performing £m	Total £m	Of which: gross new lending £m
≤50%	50,583	527	51,110	4,593
>50% and ≤70%	47,361	505	47,866	8,310
>70% and ≤80%	20,514	150	20,664	7,709
>80% and ≤90%	13,409	87	13,496	8,239
>90% and ≤100%	2,559	36	2,595	1,285
>100% and ≤110%	130	14	144	1
>110% and ≤130%	114	10	124	1
>130% and ≤150%	58	5	63	
>150%	25	8	33	1

Total with LTVs	134,753	1,342	136,095	30,139
Other	512	18	530	175
Total	135,265	1,360	136,625	30,314

For the notes to this table refer to the following page.

Capital and risk management

Credit risk **Banking activities** continued

Personal portfolio (audited)

Mortgage LTV distribution by stage

Ulster Bank RoI	Mortgages					ECL provisions				ECL provisions coverage (2)			
	Stage 1	Stage 2	Stage 3	Not within IFRS 9 ECL	Total	Stage 1	Stage 2	Stage 3	Total	Stage 1	Stage 2	Stage 3	Total
2018	£m	£m	£m	£m	£m	£m	£m	£m	£m	%	%	%	%
≤50%	3,818	374	463		4,655	1	5	40	46		1.4	8.6	1.0
>50% and ≤70%	3,567	365	459		4,391	2	10	47	59		2.7	10.3	1.3
>70% and ≤80%	1,564	190	241		1,995	1	11	52	64	0.1	5.5	21.5	3.2
>80% and ≤90%	1,059	184	272		1,515	2	15	82	99	0.2	8.3	30.2	6.5
>90% and ≤100%	570	154	261		985	2	17	99	118	0.4	11.1	37.7	11.9
>100% and ≤110%	197	80	207		484	2	10	85	97	0.9	12.8	41.1	20.1
>110% and ≤130%	51	35	179		265		6	84	90	0.8	16.6	47.0	34.0
>130% and ≤150%	5	5	37		47		1	20	21	0.3	19.1	54.7	45.2
>150%	10	1	13		24		1	7	8	2.1	27.2	58.9	33.5
Total with LTVs	10,841	1,388	2,132		14,361	10	76	516	602	0.1	5.4	24.2	4.2

	Performing	Non-performing	Total
2017	£m	£m	£m
≤50%	3,743	333	4,076
>50% and ≤70%	3,600	382	3,982
>70% and ≤80%	1,858	233	2,091
>80% and ≤90%	1,420	273	1,693
>90% and ≤100%	1,070	309	1,379
>100% and ≤110%	814	317	1,131
>110% and ≤130%	378	414	792
>130% and ≤150%	20	126	146
>150%	23	39	62
Total with LTVs	12,926	2,426	15,352

Notes:

(1) Excludes a non-material amount of provisions held on relatively small legacy portfolios.
(2) ECL provisions coverage is ECL provisions divided by drawn exposure.

Key point

- ECL coverage rates increase through the LTV bands with both UK PB and Ulster Bank RoI having only limited exposures in the highest LTV bands. The relatively high coverage level in the lowest LTV band for UK PB included the effect of time-discounting on expected recoveries. Additionally, this also reflected the modelling approach that recognised an element of expected loss on mortgages that are not subject to formal repossession activity.

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Capital and risk management

Credit risk **Banking activities** continued

Personal portfolio (audited)

UK PB Mortgage LTV distribution by region

2018	≤50% £m	50% ≤80% £m	80% ≤100% £m	100% ≤150% £m	>150% £m	Total £m	Weighted average LTV %	Other £m	Total £m	Total %
South East	14,699	17,147	2,843	8		34,697	53	27	34,724	25
Greater London	12,928	9,614	1,298	3		23,843	48	19	23,862	17
Scotland	3,205	5,612	1,844	11		10,672	60	8	10,680	8
North West	4,163	7,756	1,970	6		13,895	59	12	13,907	10
South West	4,231	6,843	1,292	8		12,374	57	9	12,383	9
West Midlands	3,036	5,642	1,192	4		9,874	58	7	9,881	7
Rest of the UK	8,942	17,548	6,056	217	16	32,779	62	34	32,813	24
Total	51,204	70,162	16,495	257	16	138,134	56	116	138,250	100
2017										
South East	14,606	16,908	2,729	10		34,253	53	96	34,349	25
Greater London	13,592	9,900	1,322	3		24,817	48	112	24,929	18
Scotland	2,850	5,341	2,423	45		10,659	63	34	10,693	8
North West	4,125	7,510	2,131	11		13,777	59	63	13,840	10
South West	4,181	6,572	1,055	9		11,817	56	40	11,857	9
West Midlands	2,578	5,264	1,503	6		9,351	61	42	9,393	7
Rest of the UK	9,175	17,037	4,929	247	33	31,421	60	143	31,564	23
Total	51,107	68,532	16,092	331	33	136,095	56	530	136,625	100

Commercial real estate (CRE)

The CRE portfolio comprises exposures to entities involved in the development of, or investment in, commercial and residential properties (including house builders but excluding housing associations, construction and building materials). The sector is reviewed regularly at senior executive committees. Reviews include portfolio credit quality, capital consumption and control frameworks. All disclosures in the CRE section are based on current exposure (gross of provisions and risk transfer). Current exposure is defined as: loans; the amount drawn under a credit facility plus accrued interest; contingent obligations; the issued amount of the guarantee or letter of credit; derivatives - the mark to market value, netted where netting agreements exist and net of legally enforceable collateral.

	2018				2017			
By geography and sub sector (1)	UK £m	RoI £m	Other £m	Total £m	UK £m	RoI £m	Other £m	Total £m
Investment								
Residential (2)	4,426	363	54	4,843	4,319	227	39	4,585

Office (3)	2,889	164	651	3,704	3,055	235	600	3,890
Retail (4)	5,168	40	92	5,300	5,401	42	132	5,575
Industrial (5)	2,270	51	176	2,497	2,438	36	14	2,488
Mixed/other (6)	3,221	180	123	3,524	4,609	203	228	5,040
	17,974	798	1,096	19,868	19,822	743	1,013	21,578
Development								
Residential (2)	2,715	122	124	2,961	3,107	145	154	3,406
Office (3)	192			192	169			169
Retail (4)	94	7	1	102	187	5	2	194
Industrial (5)	119	2	12	133	49			49
Mixed/other (6)	32	2		34	59	3		62
	3,152	133	137	3,422	3,571	153	156	3,880
Total	21,126	931	1,233	23,290	23,393	896	1,169	25,458

Notes:

(1) Geographical splits are based on country of collateral risk.

(2) Residential properties including houses, flats and student accommodation.

(3) Office properties including offices in central business districts, regional headquarters and business parks.

(4) Retail properties including high street retail, shopping centres, restaurants, bars and gyms.

(5) Industrial properties including distribution centres, manufacturing and warehouses.

(6) Mixed usage or other properties that do not fall within the other categories above. Mixed generally relates to a mixture of retail/office with residential.

Capital and risk management

Credit risk **Banking activities** continued

Commercial real estate (CRE)

CRE LTV distribution by stage (audited)

The table below summarises CRE current exposure and related ECL by LTV band.

	2018													2017		
	Current exposure (gross of provisions) (1,2)					ECL provisions				ECL provisions coverage (4)						
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Not within IFRS 9 scope (3) £m	Total £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Stage 1 %	Stage 2 %	Stage 3 %	Total %	Performing £m	Non-performing £m	Total £m
≤50%	8,229	245	52	795	9,321	7	4	14	25	0.1	1.7	26.4	0.3	9,622	66	9,688
>50% and ≤70%	4,769	297	78	703	5,847	6	6	14	26	0.1	2.0	17.8	0.5	6,621	119	6,740
>70% and ≤80%	394	43	33	6	476	1	1	8	10	0.3	2.6	23.4	2.1	405	52	457
>80% and ≤90%	55	11	24	2	92			5	5	0.3	3.4	20.9	6.1	158	42	200
>90% and ≤100%	31	7	20	1	59			7	7	0.6	5.1	34.9	12.9	89	31	120
>100% and ≤110%	53	4	15		72			5	5	0.3	4.2	34.6	7.6	34	21	55
>110% and ≤130%	22	3	111	4	140			22	22	0.4	5.4	19.4	16.0	60	421	481
>130% and ≤150%	6	10	10		26		1	4	5	0.9	6.3	40.6	18.1	44	29	73
>150%	30	6	42		78		1	29	30	0.5	9.8	69.6	38.1	149	72	221
Total with LTVs	13,589	626	385	1,511	16,111	14	13	108	135	0.1	2.1	27.9	0.9	17,182	853	18,035
Total portfolio average LTV%	45	56	114	48	47	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	48	119	51
Other (5)	2,655	133	784	185	3,757	4	5	50	59	0.2	4.0	6.3	1.7	3,112	431	3,543
Development (6)	2,865	205	178	174	3,422	11	3	80	94	0.4	1.6	44.8	2.9	3,634	246	3,880
Total	19,109	964	1,347	1,870	23,290	29	21	238	288	0.2	2.3	17.6	1.3	23,928	1,530	25,458

Notes:

(1) CRE current exposure comprises gross lending, interest rate hedging derivatives and other assets carried at fair value that are managed as part of the overall CRE portfolio.

(2) The exposure in Stage 3 mainly related to legacy assets.

(3) Includes exposures relating to non-modelled portfolios and other exposures carried at fair value, including derivatives.

(4) ECL provisions coverage is ECL provisions divided by current exposure.

(5) Relates mainly to business banking, rate risk management products and unsecured corporate lending. The low Stage 3 ECL provisions coverage was driven by a single large exposure, which has been written down to the expected recoverable amount.

(6) Relates to the development of commercial and residential properties. LTV is not a meaningful measure for this type of lending activity.

Key points (audited)

- Overall The majority of the CRE portfolio was managed in the UK within Commercial Banking, Private Banking and UK PB. The remainder was managed in Ulster Bank RoI and NatWest Markets. Business appetite and strategy remain aligned across the segments.

- 2018 trends Growth in the commercial property market slowed during 2018.

- Performance varied widely by sub-sector with strong growth from industrials contrasting with material decline in parts of the retail sector.

- Credit quality The CRE retail portfolio had a low default rate, with a limited number of new defaults. The sub-sector was monitored on a regular basis and credit quality was in line with the wider CRE portfolio.

- Economics Fundamentals such as rental incomes, property values and investor/occupier demand for other commercial sub-sectors appeared more robust, however, all are exposed to some degree to the risk of a disorderly exit from the EU. Conditions for the mainstream residential sector remained resilient, supported by mortgage availability and high levels of employment. However, the higher value end of the market was characterised by low transaction volumes.

- Risk appetite Lending criteria for commercial real estate were at conservative levels, contributing to materially reduced leverage for new origination in London offices and parts of the retail sector.

Capital and risk management

Credit risk Banking activities continued

Flow statements (audited)

The ECL flow statements analyse the key elements that drive the movement of ECL and related income statement over the reporting period. The key themes are:

- The flow statements capture the changes in ECL as well as the changes in related financial assets used in determining ECL. Exposures in this section may therefore differ from those reported in other tables in the credit risk section, principally in relation to exposures in Stage 1 and Stage 2. These differences do not have a material ECL impact.

- Financial assets presented in the flow statements include treasury liquidity portfolios, comprising balances at central banks and debt securities, as well as loans. Both modelled and non-modelled portfolios are included.

- Inter-Group transfers were a feature of the ECL flows during 2018 as a result of ring-fencing related changes. These transfers had no impact at a RBS Group-wide level.

- Stage transfers (for example, exposures moving from Stage 1 to Stage 2) these transfers are a key feature of the ECL movements, with the net re-measurement cost of transitioning to a worse stage being a primary driver of income statement charges for the period (likewise there is an ECL benefit for accounts improving stage).

- Changes in risk parameters captures the reassessment of the ECL within a given stage, including any ECL overlays and residual income statement gains or losses at the point of write-off or accounting write-down.

- Other (P&L only items) includes any subsequent changes in the value of written-down assets (for example, fortuitous recoveries) along with other direct write-off items such as direct recovery costs. Note: other (P&L only items) only affects the income statement and does not impact the balance sheet ECL movements.

- Amounts written-off represent the gross asset written-down against accounts with ECL, including the net asset write-down for debt sale activity.

- There were small amounts of ECL flows from Stage 3 to Stage 1 during the year. This does not however indicate that accounts can return from Stage 3 to Stage 1 directly. On a similar basis, flows from Stage 1 to Stage 3 were observed, however this also included legitimate transfers due to unexpected default events. The small number of write-offs in Stage 1 and 2 reflect the effect of portfolio debt sales and also staging at the start of the analysis period.

- The impact of model changes during 2018 were not material at a RBS Group-wide level or on the portfolios disclosed below.

	Stage 1		Stage 2		Stage 3		Total	
	Financial assets	ECL	Financial assets	ECL	Financial assets	ECL	Financial assets	ECL
Group total	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January 2018	419,038	262	29,637	621	10,595	3,565	459,270	4,448
Currency translation and other adjustments	1,820	(6)	88	17	50	(11)	1,958	
Transfers from Stage 1 to Stage 2	(18,416)	(52)	18,416	52				
Transfers from Stage 2 to Stage 1	13,723	228	(13,723)	(228)				
Transfers to Stage 3	(1,205)	(3)	(1,837)	(108)	3,042	111		
Transfers from Stage 3	1,272	16	1,523	163	(2,795)	(179)		
Net re-measurement of ECL on stage transfer		(207)		247		447		487
Changes in risk parameters (model inputs)		34		74		36		144
Other changes in net exposure	6,312	29	(6,716)	(32)	(1,633)	(85)	(2,037)	(88)
Other (P&L only items - primarily fortuitous recoveries)		1		3		(149)		(145)
Income statement (releases)/charges		(143)		292		249		398
Amounts written-off	(3)	(3)	(28)	(28)	(1,463)	(1,463)	(1,494)	(1,494)
Other movements		(1)		(6)		(94)		(101)
At 31 December 2018	422,541	297	27,360	772	7,796	2,327	457,697	3,396
Net carrying amount	422,244		26,588		5,469		454,301	

The following flow statements provide insight into the material portfolios underpinning the Group flow statements.

Personal

The following flow statements are at a portfolio level.

UK PB - mortgages								
At 1 January 2018	124,180	11	10,621	64	1,353	157	136,154	232
Transfers from Stage 1 to Stage 2	(4,928)	(1)	4,928	1				
Transfers from Stage 2 to Stage 1	4,245	15	(4,245)	(15)				
Transfers to Stage 3	(61)		(327)	(5)	388	5		
Transfers from Stage 3	7		235	23	(242)	(23)		
Net re-measurement of ECL on stage transfer		(15)		11		17		13
Changes in risk parameters (model inputs)				4		51		55
Other changes in net exposure	4,228		(970)	(6)	(257)	(14)	3,001	(20)
Other (P&L only items)		1				(6)		(5)
Income statement (releases)/charges		(14)		9		48		43
Amounts written-off			(1)	(1)	(26)	(26)	(27)	(27)
Other movements				(2)		(35)		(37)
At 31 December 2018	127,671	10	10,241	74	1,216	132	139,128	216
Net carrying amount	127,661		10,167		1,084		138,912	

Key points

- Overall ECL reduction was primarily driven by business-as-usual write-offs in Stage 3.

- Stage 1 ECL levels remained steady despite portfolio growth during 2018 as a result of modest PD reduction, with Stage 2 ECL showing an increase as a result of some additional forward-looking provisions being taken during the year.

- Transfers from Stage 3 back to the performing book were higher than those in Personal unsecured lending, due to the higher cure activity typically seen in mortgages.

- The increase in Stage 3 ECL changes in risk parameters reflected the monthly assessment of the loss requirement, capturing underlying changes in risk and forward-looking assessments.

- Write-off of any residual shortfall following the sale of a repossessed property typically occurs within five years, although this period can be longer, reflecting the ongoing support for customers who engage constructively with RBS.

Capital and risk management

Credit risk Banking activities continued

Flow statements (audited)

UK PB - credit cards	Stage 1 Financial assets £m	Stage 1 ECL £m	Stage 2 Financial assets £m	Stage 2 ECL £m	Stage 3 Financial assets £m	Stage 3 ECL £m	Total Financial assets £m	Total ECL £m
At 1 January 2018	2,841	52	997	94	105	75	3,943	221
Transfers from Stage 1 to Stage 2	(739)	(15)	739	15				
Transfers from Stage 2 to Stage 1	763	50	(763)	(50)				
Transfers to Stage 3	(42)	(1)	(88)	(20)	130	21		
Transfers from Stage 3	1	1	2	1	(3)	(2)		
Net re-measurement of ECL on stage transfer		(38)		66		68		96
Changes in risk parameters (model inputs)		(15)				(4)		(19)
Other changes in net exposure	(192)	2	343	17	(45)		106	19
Other (P&L only items)		3		(1)		(11)		(9)
Income statement (releases)/charges		(48)		82		53		87
Amounts written-off			(4)	(4)	(81)	(81)	(85)	(85)
Other movements				(1)		(6)		(7)
At 31 December 2018	2,632	36	1,226	118	106	71	3,964	225
Net carrying amount	2,596		1,108		35		3,739	

Key points

- Overall ECL increased primarily due to increased levels of Stage 2 inflows in the first half of the year. This was the result of activity to calibrate and refine the criteria used to identify significant increase in credit risk, with underlying performance stable.

- Transfers from Stage 2 to Stage 1 were higher than in other personal portfolios, primarily due to the ECL assessment period being reset when cards are re-issued.

- ECL transfers from Stage 3 back to the performing book were relatively small as expected.

- The amounts in other (P&L only items) mainly reflected cash recoveries after write-off. These benefited the income statement without affecting ECL.

- Amounts written-off primarily represented charge-offs (analogous to write-off) which typically occurs after 12 missed payments, and also 2018 debt sale activity.

UK PB - other personal unsecured								
At 1 January 2018	4,518	46	1,790	164	705	582	7,013	792
Transfers from Stage 1 to Stage 2	(1,452)	(18)	1,452	18				
Transfers from Stage 2 to Stage 1	733	42	(733)	(42)				
Transfers to Stage 3	(51)	(1)	(182)	(50)	233	51		
Transfers from Stage 3	2		15	4	(17)	(4)		
Net re-measurement of ECL on stage transfer		(34)		110		114		190
Changes in risk parameters (model inputs)		2		58		(1)		59
Other changes in net exposure	1,325	19	(363)	(11)	(104)	(7)	858	1
Other (P&L only items - primarily fortuitous recoveries)						(42)		(42)
Income statement (releases)/charges		(13)		157		64		208
Amounts written-off	(2)	(2)	(9)	(9)	(322)	(322)	(333)	(333)
Other movements				(3)		(19)		(22)
At 31 December 2018	5,073	54	1,970	239	495	394	7,538	687
Net carrying amount	5,019		1,731		101		6,851	

Key points

- Overall ECL reduction was mainly driven by debt sale activity and business-as-usual write-offs in Stage 3, both reflected in amounts written-off.

- Increases in Stage 2 reflected the underlying performance of recent new business growth maturing. Additionally, the ECL overlay for economic uncertainty contributed to the uplift captured in changes in risk parameters.

- The portfolio continued to experience cash recoveries after write-off, reported in other (P&L only items primarily fortuitous recoveries). This benefited the income statement without affecting ECL.

- Write-off occurs once recovery activity with the customer has been concluded and there are no further recoveries expected, but no later than six years after default.

Capital and risk management

Credit risk **Banking activities** continued

Flow statements (audited)

	Stage 1		Stage 2		Stage 3		Total	
	Financial assets	ECL	Financial assets	ECL	Financial assets	ECL	Financial assets	ECL
Commercial Banking - business banking	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January 2018	6,505	29	684	29	268	224	7,457	282
Transfers from Stage 1 to Stage 2	(691)	(4)	691	4				
Transfers from Stage 2 to Stage 1	366	12	(366)	(12)				
Transfers to Stage 3	(35)	(1)	(63)	(8)	98	9		
Transfers from Stage 3	2	2	9	2	(11)	(4)		
Net re-measurement of ECL on stage transfer		(12)		24		43		55
Changes in risk parameters (model inputs)		(6)		2		(11)		(15)
Other changes in net exposure	156	3	(57)	3	(36)	(23)	63	(17)
Other (P&L only items)						(31)		(31)
Income statement (releases)/charges		(15)		29		(22)		(8)
Amounts written-off			(1)	(1)	(84)	(84)	(85)	(85)
Other movements		(1)				(1)		(2)
At 31 December 2018	6,303	22	897	43	235	153	7,435	218
Net carrying amount	6,281		854		82		7,217	

Key points

- Overall ECL reduction was mainly driven by business-as-usual write-offs in Stage 3.

- Stage 2 ECL did increase during the year as a result of net Stage 2 inflows from Stage 1, partly driven by PD model refinements throughout the year.

- The portfolio continued to experience cash recoveries after write-off, reported in other (P&L only items). This benefited the income statement without affecting ECL.

- Write-off occurs once recovery activity with the customer has been concluded and there are no further recoveries expected, but no later than five years after default.

Commercial Banking Other commercial								
At 1 January 2018	6,771	6	595	11	126	57	7,492	74
Currency translation and other adjustments	1						1	
Inter-Group transfers	(71)		(1)		(5)		(77)	
Transfers from Stage 1 to Stage 2	(781)	(2)	781	2				
Transfers from Stage 2 to Stage 1	389	6	(389)	(6)				
Transfers to Stage 3	(16)		(70)	(1)	86	1		
Transfers from Stage 3	1		25		(26)			
Net re-measurement of ECL on stage transfer		(4)		10		19		25
Changes in risk parameters (model inputs)		4						4
Other changes in net exposure	(886)	(1)	(123)	(1)	(62)	(6)	(1,071)	(8)
Other (P&L only items)		(2)		1		1		
Income statement (releases)/charges		(3)		10		14		21
Amounts written-off					(27)	(27)	(27)	(27)
Other movements						(1)		(1)
At 31 December 2018	5,408	9	818	15	92	43	6,318	67
Net carrying amount	5,399		803		49		6,251	

Key point

- Overall ECL reduced slightly during the year, with some modest Stage 1 and Stage 2 ECL increases being more than offset by Stage 3 write-offs, which was the key driver of the overall income statement charge for 2018.

Capital and risk management

Credit risk **Banking activities** continued

Flow statements (audited)

	Stage 1		Stage 2		Stage 3		Total	
	Financial assets	ECL	Financial assets	ECL	Financial assets	ECL	Financial assets	ECL
Ulster Bank RoI - mortgages	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January 2018	10,650	8	1,532	72	3,167	881	15,349	961
Currency translation and other adjustments	94		12	1	15	3	121	4
Transfers from Stage 1 to Stage 2	(344)	(1)	344	1				
Transfers from Stage 2 to Stage 1	414	7	(414)	(7)				
Transfers to Stage 3	(32)		(124)	(8)	156	8		
Transfers from Stage 3	4		245	36	(249)	(36)		
Net re-measurement of ECL on stage transfer		(6)		(4)		11		1
Changes in risk parameters (model inputs)		3		(1)		(23)		(21)
Other changes in net exposure	(4)		(188)	(2)	(630)	14	(822)	12
Other (P&L only items)		(2)		2		28		28
Income statement (releases)/charges		(5)		(5)		30		20
Amounts written-off			(13)	(13)	(322)	(322)	(335)	(335)
Other movements						(20)		(20)
At 31 December 2018	10,782	11	1,394	75	2,137	516	14,313	602
Net carrying amount	10,771		1,319		1,621		13,711	

Key points

- The overall ECL reduction was driven by reduced ECL in Stage 3, which was subject to significant debt sale activity in 2018 (approximately £0.9 billion of gross exposures were sold during the year).

- In addition to the debt sale activity, the reduction in ECL in Stage 3 reflected ongoing improvements in underlying portfolio performance.

- The reduction in Stage 2 exposures resulted from the portfolio debt sale and decreasing stock of exposures meeting the high-risk backstop criteria. This reflected ongoing improvements in the underlying portfolio performance.

- Write-off generally occurs once the repossessed property has been sold and there is a residual shortfall balance remaining outstanding which has been deemed irrecoverable.

Wholesale

Commercial Banking								
At 1 January 2018	84,228	58	9,056	106	3,735	1,156	97,019	1,320
Currency translation and other adjustments	367		47	(1)	29	(4)	443	(5)
Inter-Group transfers	(2,106)	(1)	(92)		(375)	(14)	(2,573)	(15)
Transfers from Stage 1 to Stage 2	(8,224)	(9)	8,224	9				
Transfers from Stage 2 to Stage 1	5,911	52	(5,911)	(52)				
Transfers to Stage 3	(881)		(938)	(13)	1,819	13		
Transfers from Stage 3	1,056	11	937	89	(1,993)	(100)		
Net re-measurement of ECL on stage transfer		(57)		13		160		116
Changes in risk parameters (model inputs)		46		8		41		95
Other changes in net exposure	(4,274)	(1)	(2,748)	(19)	(489)	(40)	(7,511)	(60)
Other (P&L only items)				1		(8)		(7)
Income statement (releases)/charges		(12)		3		153		144
Amounts written-off					(460)	(460)	(460)	(460)
Other movements						(10)		(10)
At 31 December 2018	76,077	99	8,575	140	2,266	742	86,918	981
Net carrying amount	75,978		8,435		1,524		85,937	

Key points

- ECL reduced over the course of 2018 as write-offs outweighed ECL charges.

- Stage 3 charges were mainly driven by a charge on new to default exposures where the ECL can increase significantly following an individual assessment.

- Stage 1 and Stage 2 changes to risk parameters largely reflected the increase in ECL for economic uncertainty and a change to the forward-looking modelling approach for point-in-time PDs, where PDs now revert to long-run average after one year rather than five years.

- Inter-Group transfers reflected the impact of transfers completed in preparation of ring-fencing. The reductions in net exposure were also related to ring-fencing changes, where short-term borrowing was renewed in other franchises.

- Release in Stage 1 was driven by a reduction in ECL for exposures transferring from Stage 2 and Stage 3, which previously had a lifetime ECL but are now assessed for 12 month ECL.

Capital and risk management

Credit risk **Banking activities** continued

Flow statements (audited)

	Stage 1		Stage 2		Stage 3		Total	
	Financial assets	ECL	Financial assets	ECL	Financial assets	ECL	Financial assets	ECL
NatWest Markets (1)	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January 2018	9,089	2	1,276	42	456	190	10,821	234
Currency translation and other adjustments	252		22	(2)	3	3	277	1
Inter-Group transfers	3,590		(4)	1	374	14	3,960	15
Transfers from Stage 1 to Stage 2	(393)		393					
Transfers from Stage 2 to Stage 1	318	28	(318)	(28)				
Transfers to Stage 3			(3)		3			
Transfers from Stage 3			35		(35)			
Net re-measurement of ECL on stage transfer		(26)		5				(21)
Changes in risk parameters (model inputs)		(5)		4				(1)
Other changes in net exposure	19,902	8	(669)	(8)	(4)	(6)	19,229	(6)
Other (P&L only items - primarily fortuitous recoveries)						(64)		(64)
Income statement (releases)/charges		(23)		1		(70)		(92)
Amounts written-off					(89)	(89)	(89)	(89)
Other movements								
At 31 December 2018	32,758	7	732	14	708	112	34,198	133
Net carrying amount	32,751		718		596		34,065	

Note:

(1) Reflects NatWest Markets segments and include NWM N.V..

Key points

- Stage 3 financial assets include £166 million (1 January 2018 £105 million) purchased or originated credit impaired (POCI) assets. No ECL impairment was held on these positions and a £61 million impairment recovery was recognised on these POCI assets during 2018 (included in other (P&L only items primarily fortuitous recoveries)).

- Stage 1 and Stage 2 changes to risk parameters largely reflected the increase in ECL for economic uncertainty, and a change to the forward-looking modelling approach for point-in-time PDs, where PDs now revert to long run average after one year rather than five years.

- The release in Stage 1 was driven by a reduction in ECL on exposures transferring from Stage 2, which previously had a lifetime ECL but are now assessed for 12 month ECL.

- The increase in Stage 1 exposure was due to a combination of transfers and short-term borrowing to governments and central banks which are now in NatWest Markets following changes in preparation for ring-fencing.

- The portfolio experienced fortuitous recoveries, reported in other (P&L only items primarily fortuitous recoveries). This benefited the income statement without affecting ECL.

Private Banking								
At 1 January 2018	13,046	18	412	9	300	27	13,758	54
Currency translation and other adjustments	12		1	2			13	2
Inter-Group transfers	23						23	
Transfers from Stage 1 to Stage 2	(270)	(1)	270	1				
Transfers from Stage 2 to Stage 1	92	2	(92)	(2)				
Transfers to Stage 3	(60)		(8)		68			
Transfers from Stage 3	7		1		(8)			
Net re-measurement of ECL on stage transfer		(2)		3		1		2
Changes in risk parameters (model inputs)		(3)		(2)		1		(4)
Other changes in net exposure	1,100		(65)	(1)	(121)	(2)	914	(3)
Other (P&L only items)						(1)		(1)
Income statement releases		(5)				(1)		(6)
Amounts written-off					(7)	(7)	(7)	(7)
Other movements						(1)		(1)
At 31 December 2018	13,950	14	519	10	232	19	14,701	43
Net carrying amount	13,936		509		213		14,658	

Key points

- ECL reduced due to a combination of write-offs and impairment releases.

- The majority of the release was in Stage 1, due to a reduction in loss rates for Retail exposures.

- Exposure increased in Stage 1 reflecting growth in the portfolio (primarily mortgages driven) with minimal ECL impact due to high credit quality.

Capital and risk management

Credit risk **Banking activities** continued

Flow statements (audited)

	Stage 1		Stage 2		Stage 3		Total	
	Financial assets	ECL	Financial assets	ECL	Financial assets	ECL	Financial assets	ECL
RBS International	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January 2018	8,652	5	385	5	118	28	9,155	38
Currency translation and other adjustments	98	(2)		2		(1)	98	(1)
Inter-Group transfers	1,834		95				1,929	
Transfers from Stage 1 to Stage 2	(299)		299					
Transfers from Stage 2 to Stage 1	340	5	(340)	(5)				
Transfers to Stage 3	(14)		(11)		25			
Transfers from Stage 3	190		4		(194)			
Net re-measurement of ECL on stage transfer		(4)		2				(2)
Changes in risk parameters (model inputs)		2						2
Other changes in net exposure	15,948		(156)		155	(1)	15,947	(1)
Other (P&L only items)		(1)		1		(1)		(1)
Income statement (releases)/charges		(3)		3		(2)		(2)
Amounts written-off					(9)	(9)	(9)	(9)
Other movements								
At 31 December 2018	26,749	6	276	4	95	17	27,120	27
Net carrying amount	26,743		272		78		27,093	

Key points

- The reduction in ECL was driven by write-offs and Stage 3 impairment releases, both of which are primarily in the Spanish mortgage portfolio.

- The increases in exposure were partly due to new lending, but mainly due to the establishment of a liquidity portfolio across central and correspondent banks and sovereign bond holdings. These exposures were in Stage 1 with very low credit risk and contribute minimal ECL.

Capital and risk management

Credit risk Banking activities continued

Stage 2 decomposition arrears status and contributing factors

The tables below summarise Stage 2 decomposition for the Personal and Wholesale portfolios.

	UK mortgages		RoI mortgages		Other mortgages		Credit cards		Other		Total	
	Loans	ECL	Loans	ECL	Loans	ECL	Loans	ECL	Loans	ECL	Loans	ECL
31 December 2018	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Personal												
Currently in arrears (>30 DPD)	658	10	90	10	3		17	6	88	22	856	48
Currently up-to-date	9,612	64	1,292	66			1,226	114	1,985	225	14,115	469
- PD deterioration	*3,855*	*54*	*680*	*44*			*778*	*85*	*1,255*	*176*	*6,568*	*359*
- Up-to-date, PD persistence	*1,448*	*5*	*54*	*1*			*337*	*17*	*440*	*26*	*2,279*	*49*
- Other driver (adverse credit, forbearance etc)	*4,309*	*5*	*558*	*21*			*111*	*12*	*290*	*23*	*5,268*	*61*
Total Stage 2	10,270	74	1,382	76	3		1,243	120	2,073	247	14,971	517

Key point

- In Personal exposures, as expected, ECL coverage was higher on accounts that are more than 30 days past due. Also in line with expectations, accounts exhibiting PD deterioration have a higher ECL coverage than accounts in Stage 2 for other reasons.

	Property		Corporate		FI		Other		Total	
	Loans	ECL	Loans	ECL	Loans	ECL	Loans	ECL	Loans	ECL
31 December 2018	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Wholesale										
Currently in arrears (>30 DPD)	255	7	315	5	1				571	12
Currently up-to-date	1,622	32	8,438	195	473	7	22		10,555	234
- PD deterioration	*924*	*23*	*5,564*	*138*	*281*	*6*	*8*		*6,777*	*167*
- Up-to-date, PD persistence	*57*	*1*	*170*	*5*	*4*				*231*	*6*
- Other driver (forbearance, RoCL etc.)	*641*	*8*	*2,704*	*52*	*188*	*1*	*14*		*3,547*	*61*
Total Stage 2	1,877	39	8,753	200	474	7	22		11,126	246

Key point

- In Wholesale exposures, the ECL coverage was broadly consistent in total. Coverage can vary across categories or sectors reflecting the individual characteristics of the customer and exposure type.

Stage 2 decomposition by SICR trigger

31 December 2018	UK mortgages £m	%	RoI mortgages £m	%	Other mortgages £m	%	Credit cards £m	%	Other £m	%	Total £m	%
Personal trigger (1)												
PD movement	4,273	41.6	767	55.6			793	63.8	1,307	63.0	7,140	47.7
PD persistence	1,450	14.1	54	3.9			338	27.2	440	21.2	2,282	15.2
Adverse credit bureau recorded with credit reference agency	2,996	29.2					61	4.9	101	4.9	3,158	21.1
Forbearance support provided	206	2.0	2	0.1					13	0.6	221	1.5
Customers in collections	144	1.4	57	4.1			5	0.4	36	1.7	242	1.6
Other reasons (2)	982	9.6	502	36.3			46	3.7	151	7.3	1,681	11.2
Days past due >30	219	2.1			3	100.0			25	1.2	247	1.6
	10,270	100	1,382	100	3	100	1,243	100	2,073	100	14,971	100

Key point

- The primary driver of credit deterioration was PD, which including persistence, accounted for the majority of movements to Stage 2. High risk back-stops, for example, forbearance, adverse credit bureau, provide additional valuable discrimination particularly on mortgages.

31 December 2018	Property £m	%	Corporate £m	%	FI £m	%	Other £m	%	Total £m	%
Wholesale trigger (1)										
PD movement	940	50.1	5,617	64.2	281	59.3	8	36.4	6,845	61.5
PD persistence	57	3.0	171	2.0	4	0.8			232	2.1
Risk of Credit Loss	321	17.1	1,964	22.4	103	21.7			2,388	21.5
Forbearance support provided	65	3.5	209	2.4					274	2.5
Customers in collections	9	0.5	43	0.5					52	0.5
Other reasons (3)	251	13.4	525	6.0	85	17.9	14	63.6	875	7.9
Days past due >30	234	12.5	224	2.6	1	0.2			460	4.1
	1,877	100	8,753	100	474	100	22	100	11,126	100

Notes:

(1) The data table is built on a hierarchical basis from top to bottom, for example, accounts with PD deterioration may also trigger backstop(s) but are only reported under PD deterioration.

(2) Includes customers who have accessed payday lending, interest only mortgages past end of term, a small number of mortgage customers on a highly flexible mortgage significantly behind their outline repayment plan and customers breaching risk appetite thresholds for new business acquisition. On the RoI mortgage portfolio, this reflected customers who remained in probation following the conclusion of forbearance support, exposures breaching risk appetite thresholds for new business acquisition and exposures classified as non-performing exposures under EBA requirements.

(3) Includes customers where a PD assessment cannot be undertaken due to missing PDs.

Key point

- The primary driver of credit deterioration was PD, which including persistence, accounted for 62% of Stage 2. The Risk of Credit Loss framework accounted for a further 21% highlighting the importance of expert judgement being used to identify deterioration.

Capital and risk management

Credit risk Banking activities continued

Stage 3 vintage analysis

The table below provides estimated vintage analysis of the material Stage 3 portfolios totalling 87% of the Stage 3 loans of £7.7 billion.

2018	UK PB mortgages	Ulster RoI mortgages	Wholesale
Stage 3 loans (£bn)	1.2	2.1	3.4
Vintage (time in default):			
<1 year	26%	7%	22%
1-3 years	21%	12%	19%
3-5 years	14%	14%	9%
5-10 years	35%	63%	50%
>10 years	4%	4%	
	100%	100%	100%

Key points

- Mortgages The proportion of the Stage 3 defaulted population who have been in default for over five years reflected RBS s support for customers in financial difficulty. When customers continue to engage constructively with RBS making regular payments, RBS continues to support them. RBS s provisioning approach retains customers in Stage 3 for a life-time loss provisioning calculation even when their arrears status reverts to below 90 days past due.

- Wholesale The value of Stage 3 loans that have been impaired for 5-10 years was mainly due to customers being in a protracted formal insolvency process or subject to litigation or a complaints process.

Asset quality (audited)

Asset quality analysis is based on internal asset quality ratings which have ranges for the probability of default. Customers are assigned credit grades, based on various credit grading models that reflect the key drivers of default for the customer type. All credit grades across RBS map to both an asset quality scale, used for external financial reporting, and a master grading scale for wholesale exposures used for internal management reporting across portfolios. The table that follows details the relationship between internal asset quality (AQ) bands and external ratings published by Standard & Poor s (S&P), for illustrative purposes only. This relationship is established by observing S&P s default study statistics, notably the one year default rates for each S&P rating grade. A degree of judgement is required to relate the probability of default ranges associated with the master grading scale to these default rates given that, for example, the S&P published default rates do not increase uniformly by grade and the historical default rate is nil for the highest rating categories.

Internal asset quality band	Probability of default range	Indicative S&P rating
AQ1	0% - 0.034%	AAA to AA
AQ2	0.034% - 0.048%	AA to AA-
AQ3	0.048% - 0.095%	A+ to A
AQ4	0.095% - 0.381%	BBB+ to BBB-
AQ5	0.381% - 1.076%	BB+ to BB
AQ6	1.076% - 2.153%	BB- to B+
AQ7	2.153% - 6.089%	B+ to B
AQ8	6.089% - 17.222%	B- to CCC+
AQ9	17.222% - 100%	CCC to C
AQ10	100%	D

The mapping to the S&P ratings is used by RBS as one of several benchmarks for its wholesale portfolios, depending on customer type and the purpose of the benchmark. The mapping is based on all issuer types rated by S&P. It should therefore be considered illustrative and does not, for instance, indicate that exposures reported against S&P ratings either have been or would be assigned those ratings if assessed by S&P. In addition, the relationship is not relevant for retail portfolios, smaller corporate exposures or specialist corporate segments given that S&P does not typically assign ratings to such entities.

Capital and risk management

Credit risk **Banking activities** continued

Asset quality (audited)

The table below summarises asset quality bands of gross loans and ECL by stage for the Personal portfolio.

	Gross loans				ECL provisions				ECL provisions coverage			
	Stage 1	Stage 2	Stage 3	Total	Stage 1	Stage 2	Stage 3	Total	Stage 1	Stage 2	Stage 3	Total
2018	£m	£m	£m	£m	£m	£m	£m	£m	%	%	%	%
UK mortgages												
AQ1-AQ4	95,618	3,621		99,239	6	11		17	0.01	0.30		0.02
AQ5-AQ8	42,771	5,845		48,616	6	46		52	0.01	0.79		0.11
AQ9	32	804		836		17		17		2.11		2.03
AQ10			1,541	1,541			151	151			9.80	9.80
	138,421	10,270	1,541	150,232	12	74	151	237	0.01	0.72	9.80	0.16
RoI mortgages												
AQ1-AQ4	5,164	226		5,390	4	5		9	0.08	2.21		0.17
AQ5-AQ8	5,668	717		6,385	7	32		39	0.12	4.46		0.61
AQ9	12	439		451		39		39		8.88		8.65
AQ10 (1)			2,124	2,124			515	515			24.25	24.25
	10,844	1,382	2,124	14,350	11	76	515	602	0.10	5.50	24.25	4.20
Other mortgages												
AQ1-AQ4	359	1		360								
AQ5-AQ8	136	2		138								
AQ10			1	1								
	495	3	1	499								
Credit cards												
AQ1-AQ4	34	1		35								
AQ5-AQ8	2,810	1,180		3,990	38	103		141	1.35	8.73		3.53
AQ9	7	62		69		17		17		27.42		24.64
AQ10			122	122			72	72			59.02	59.02
	2,851	1,243	122	4,216	38	120	72	230	1.33	9.65	59.02	5.46
Other												
AQ1-AQ4	997	43		1,040	4	5		9	0.40	11.63		0.87
AQ5-AQ8	5,889	1,847		7,736	55	186		241	0.93	10.07		3.12
AQ9	56	183		239	2	56		58	3.57	30.60		24.27
AQ10			563	563			420	420			74.60	74.60
	6,942	2,073	563	9,578	61	247	420	728	0.88	11.92	74.60	7.60
Total												
AQ1-AQ4	102,172	3,892		106,064	14	21		35	0.01	0.54		0.03
AQ5-AQ8	57,274	9,591		66,865	106	367		473	0.19	3.83		0.71
AQ9	107	1,488		1,595	2	129		131	1.87	8.67		8.21
AQ10			4,351	4,351			1,158	1,158			26.61	26.61
	159,553	14,971	4,351	178,875	122	517	1,158	1,797	0.08	3.45	26.61	1.00

Note:

(1) At 31 December 2018, AQ10 includes £0.6 billion RoI mortgages which are not currently considered defaulted for capital calculation purposes for RoI but included in Stage 3.

Key points

- The majority of exposures were in AQ1-AQ4, with a significant proportion in AQ5-AQ8. As expected, mortgage exposures have a higher proportion in AQ1-AQ4 than unsecured borrowing.

- The relatively high level of Stage 3 impaired assets (AQ10) in RoI mortgages reflected their legacy mortgage portfolio and the residual effects from the financial crisis. In other personal, the relatively high level of exposures in AQ10 reflected the fact that impaired assets can be held on balance sheet with commensurate ECL provision for up to six years after default.

- ECL provisions coverage shows the expected trend with increased coverage in the poorer asset quality bands, and also by stage.

Capital and risk management

Credit risk **Banking activities**continued

Asset quality (audited)

The table below summarises asset quality bands of gross loans and ECL by stage for the Wholesale portfolio.

	Gross loans				ECL provisions				ECL provisions coverage			
	Stage 1	Stage 2	Stage 3	Total	Stage 1	Stage 2	Stage 3	Total	Stage 1	Stage 2	Stage 3	Total
2018	£m	£m	£m	£m	£m	£m	£m	£m	%	%	%	%
Property												
AQ1-AQ4	15,740	393		16,133	8	9		17	0.05	2.29		0.11
AQ5-AQ8	17,397	1,418		18,815	35	26		61	0.20	1.83		0.32
AQ9	8	66		74		4		4		6.06		5.41
AQ10			1,685	1,685			506	506			30.03	30.03
	33,145	1,877	1,685	36,707	43	39	506	588	0.13	2.08	30.03	1.60
Corporate												
AQ1-AQ4	21,814	773		22,587	13	14		27	0.06	1.81		0.12
AQ5-AQ8	40,004	7,647		47,651	93	171		264	0.23	2.24		0.55
AQ9	26	333		359	1	15		16	3.85	4.50		4.46
AQ10			1,643	1,643			634	634			38.59	38.59
	61,844	8,753	1,643	72,240	107	200	634	941	0.17	2.28	38.59	1.30
Financial institutions												
AQ1-AQ4	22,150	247		22,397	5	5		10	0.02	2.02		0.04
AQ5-AQ8	2,352	222		2,574	7	2		9	0.30	0.90		0.35
AQ9		5		5								
AQ10			35	35			22	22			62.86	62.86
	24,502	474	35	25,011	12	7	22	41	0.05	1.48	62.86	0.16
Sovereign												
AQ1-AQ4	6,780	22		6,802	1			1	0.01			0.01
AQ5-AQ8	161			161								
AQ10			4	4								
	6,941	22	4	6,967	1			1	0.01			0.01
Total												
AQ1-AQ4	66,484	1,435		67,919	27	28		55	0.04	1.95		0.08
AQ5-AQ8	59,914	9,287		69,201	135	199		334	0.23	2.14		0.48
AQ9	34	404		438	1	19		20	2.94	4.70		4.57
AQ10			3,367	3,367			1,162	1,162			34.51	34.51
	126,432	11,126	3,367	140,925	163	246	1,162	1,571	0.13	2.21	34.51	1.11

Key points

- Across the Wholesale portfolio, the asset quality band distribution differed reflecting the diverse nature of differing sectors. 48% of Wholesale lending exposure was in the AQ1-AQ4 band.

- The relatively low provision coverage for Stage 3 loans in the property sector reflected the secured nature of the exposures.

Credit risk Trading activities

This section covers the credit risk profile of RBS s trading activities. All disclosures are audited.

Security funding transactions and collateral (audited)

The table below captures securities funding transactions in NWM and Treasury. All transactions that are outside netting arrangements are in NWM.

	Reverse repos			Repos		
	Total	Of which: can be offset	Outside netting arrangements	Total	Of which: can be offset	Outside netting arrangements
2018	£m	£m	£m	£m	£m	£m
Gross	68,044	65,057	2,987	70,097	68,940	1,157
IFRS offset	(39,737)	(39,737)		(39,737)	(39,737)	
Carrying value	28,307	25,320	2,987	30,360	29,203	1,157
Master netting arrangements	(762)	(762)		(762)	(762)	
Securities collateral	(24,548)	(24,548)		(28,441)	(28,441)	
Potential for offset not recognised under IFRS	(25,310)	(25,310)		(29,203)	(29,203)	
Net	2,997	10	2,987	1,157		1,157
2017						
Gross	84,706	78,991	5,715	82,395	80,088	2,307
IFRS offset	(43,974)	(43,974)		(43,974)	(43,974)	
Carrying value	40,732	35,017	5,715	38,421	36,114	2,307
Master netting arrangements	(329)	(329)		(329)	(329)	
Securities collateral	(34,646)	(34,646)		(35,785)	(35,785)	
Potential for offset not recognised under IFRS	(34,975)	(34,975)		(36,114)	(36,114)	
Net	5,757	42	5,715	2,307		2,307

Capital and risk management

Credit risk **Trading activities** continued

Derivatives (audited)

The table below summarises derivatives by type of contract. The master netting agreements and collateral shown below do not result in a net presentation on the balance sheet under IFRS 9. A significant proportion (more than 90%) of the derivatives relate to trading activities in NatWest Markets, the table below also includes hedging derivatives in Treasury.

	2018							2017		
	Notional									
	GBP £bn	USD £bn	Euro £bn	Other £bn	Total £bn	Assets £m	Liabilities £m	Notional £bn	Assets £m	Liabilities £m
Gross exposure						138,390	135,673		177,931	172,063
IFRS offset						(5,041)	(6,776)		(17,088)	(17,557)
Carrying value	2,895	5,129	4,323	1,632	13,979	133,349	128,897	15,482	160,843	154,506
Of which:										
Interest rate (1)										
Interest rate swaps						81,855	74,004		99,065	91,025
Options purchased						14,481			21,733	
Options written							16,371			21,021
Futures and forwards						74	69		147	114
Total	2,521	3,589	3,686	740	10,536	96,410	90,444	12,016	120,945	112,160
Exchange rate										
Spot, forwards and futures						17,904	18,610		19,283	19,172
Currency swaps						11,322	12,062		11,163	13,534
Options purchased						7,319			8,765	
Options written							7,558			8,975
Total	373	1,532	629	892	3,426	36,545	38,230	3,425	39,211	41,681
Credit	1	7	8		16	346	208	38	531	558
Equity and commodity		1			1	48	15	3	156	107
Carrying value					13,979	133,349	128,897	15,482	160,843	154,506
Counterparty mark-to-market netting						(106,762)	(106,762)		(128,287)	(128,287)
Cash collateral						(17,937)	(15,227)		(20,311)	(18,035)
Securities collateral						(4,469)	(3,466)		(5,850)	(3,952)
Net exposure						4,181	3,442		6,395	4,232
Of which outside netting arrangements						*2,061*	*1,708*		*2,261*	*1,658*
Banks (2)						362	443		461	466
Other financial institutions (3)						1,054	1,144		1,608	1,625
Corporate (4)						2,510	1,817		3,843	2,065
Government (5)						255	38		483	76
Net exposure						4,181	3,442		6,395	4,232

UK	1,935	1,304	4,079	1,853
Europe	1,308	1,465	1,643	1,777
US	588	298	346	317
RoW	350	375	327	285
Net exposure	4,181	3,442	6,395	4,232
Asset quality of uncollateralised derivative assets				
AQ1-AQ4	3,384		5,173	
AQ5-AQ8	773		1,216	
AQ9	3		3	
AQ10	21		3	
Net exposure	4,181		6,395	

Notes:

(1) The notional amount of interest rate derivatives include £5,952 billion (2017 £7,400 billion) in respect of contracts cleared through central clearing counterparties.

(2) Transactions with certain counterparties with whom RBS has netting arrangements but collateral is not posted on a daily basis; certain transactions with specific terms that may not fall within netting and collateral arrangements; derivative positions in certain jurisdictions for example China where the collateral agreements are not deemed to be legally enforceable.

(3) Transactions with securitisation vehicles and funds where collateral posting is contingent on RBS s external rating.

(4) Mainly large corporates with whom RBS may have netting arrangements in place, but operational capability does not support collateral posting.

(5) Sovereigns and supranational entities with one-way collateral agreements in their favour.

Capital and risk management

Credit risk Trading activities continued

Derivatives: settlement basis and central counterparties (audited)

The table below summarises the derivative notional and fair value by trading and settlement method.

	Notional				Asset		Liability	
		Traded over the counter						
	Traded on recognised exchanges	Settled by central counterparties	Not settled by central counterparties	Total	Traded on recognised exchanges	Traded over the counter	Traded on recognised exchanges	Traded over the counter
2018	£bn	£bn	£bn	£bn	£m	£m	£m	£m
Interest rate	1,642	5,952	2,942	10,536		96,410		90,444
Exchange rate	4		3,422	3,426		36,545		38,230
Credit			16	16		346		208
Equity and commodity			1	1		48		15
Total	1,646	5,952	6,381	13,979		133,349		128,897
2017								
Interest rate	1,506	7,400	3,110	12,016		120,945		112,160
Exchange rate	4		3,421	3,425		39,211		41,681
Credit			38	38		531		558
Equity and commodity			3	3		156	1	106
Total	1,510	7,400	6,572	15,482		160,843	1	154,505

Debt securities (audited)

The table below summarises debt securities held at mandatory fair value through profit or loss by issuer as well as ratings based on the lowest of Standard & Poor s, Moody s and Fitch. A significant proportion (more than 95%) of these positions are trading securities in NatWest Markets.

	Central and local government			Financial		
	UK	US	Other	institutions	Corporate	Total
2018	£m	£m	£m	£m	£m	£m
AAA			2,093	1,459	7	3,559
AA to AA+	6,834	4,689	3,161	773	120	15,577
A to AA-			4,571	482	51	5,104
BBB- to A-			3,592	802	285	4,679
Non-investment grade			81	832	237	1,150
Unrated				572	8	580
Total	6,834	4,689	13,498	4,920	708	30,649
Short positions	(6,394)	(2,008)	(13,500)	(1,724)	(201)	(23,827)
2017						
AAA			1,474	1,576	21	3,071

AA to AA+	3,514	3,667	2,386	984	168	10,719
A to AA-			7,224	427	78	7,729
BBB- to A-			3,267	796	493	4,556
Non-investment grade			385	552	171	1,108
Unrated				255	43	298
Total	3,514	3,667	14,736	4,590	974	27,481
Short positions	(3,490)	(2,501)	(20,390)	(1,945)	(201)	(28,527)

Credit risk Cross border exposure

Cross border exposures comprise both banking and trading activities, including reverse repurchase agreements. Exposures comprise loans and advances, including finance leases and instalment credit receivables, and other monetary assets, such as debt securities. The geographical breakdown is based on the country of domicile of the borrower or guarantor of ultimate risk. Cross border exposures include non-local currency claims of overseas offices on local residents but exclude exposures to local residents in local currencies. The table below sets out cross border exposures greater than 0.5% of RBS s total assets.

2018	Government £m	Banks £m	Other £m	Total £m	Short positions £m	Net of short positions £m
Western Europe	21,121	19,003	16,741	56,865	14,103	42,762
Of which: France	3,396	10,209	1,579	15,184	1,626	13,558
Of which: Germany	8,023	3,086	1,145	12,254	5,397	6,857
Of which: Netherlands	1,142	675	3,739	5,556	985	4,571
United States	13,558	5,458	8,379	27,395	2,103	25,292
Japan	4,857	2,327	405	7,589	11	7,578
2017						
France	4,721	11,739	2,320	18,780	3,324	15,456
Germany	7,643	5,819	2,165	15,627	9,957	5,670
Netherlands	1,897	798	5,395	8,090	986	7,104
United States	8,697	4,494	8,048	21,239	2,607	18,632
Japan	7,533	4,879	197	12,609	15	12,594
2016						
France	4,275	7,045	2,003	13,323	2,392	10,931
Germany	8,868	4,836	2,138	15,842	4,207	11,635
Netherlands	2,809	563	6,699	10,071	1,061	9,010
United States	7,677	6,012	8,138	21,827	5,099	16,728
Japan	8,291	5,441	375	14,107	1	14,106

Capital and risk management

Credit risk continued

Key IFRS 9 terms and differences to the prior IAS accounting standard and regulatory framework (audited)

Attribute	IFRS 9	IAS 39	Regulatory (CRR)
Default/credit impairment	To determine the risk of a default occurring, management applies a default definition that is consistent with the Basel/regulatory definition of default. Assets that are defaulted are shown as credit impaired. RBS uses 90 days past due as a consistent measure for default across all product classes. The population of credit impaired assets is broadly consistent with IAS 39, though measurement differs because of the application of MES. Assets that were categorised as potential problems with no impairment provision are now categorised as Stage 3.	Default aligned to loss events, all financial assets where an impairment event had taken place 100% probability of default and an internal asset quality grade of AQ10 were classed as non-performing. Impaired financial assets were those for which there was objective evidence that the amount or timing of future cash flows had been adversely impacted since initial recognition.	A default shall be considered to have occurred with regard to a particular financial asset when either or both of the following have taken place: RBS considers that the customer is unlikely to pay its credit obligations without recourse by the institution to actions such as realising security; The customer is past due more than 90 days. For Personal exposures, the definition of default may be applied at the level of an individual credit facility rather than in relation to the total obligations of a borrower.
Probability of default (PD)	PD is the likelihood of default assessed on the prevailing economic conditions at the reporting date (point in time), adjusted to take into account estimates of future economic conditions that are likely to impact the risk of default; it will not equate to a long run average.	Regulatory PDs adjusted to point in time metrics were used in the latent provision calculation.	The likelihood that a customer will fail to make full and timely repayment of credit obligations over a one year time horizon. For Wholesale, PD models reflect losses that would arise through-the-cycle; this represents a long run average view of default levels. For Personal, the prevailing economic conditions at the reporting date (point-in-time) are used.
Significant increase in credit risk (SICR)	A framework incorporating both quantitative and qualitative measures aligned to the Group s current risk management framework has been established. Credit deterioration will be a management decision, subject to approval by governing bodies such as the Provisions Committee.	Not applicable.	Not applicable.

	The staging assessment requires a definition of when a SICR has occurred; this moves the loss calculation for financial assets from a 12 month horizon to a lifetime horizon. Management has established an approach that is primarily informed by the increase in lifetime probability of default, with additional qualitative measures to account for assets where PD does not move, but a high risk factor is determined.		
Forward-looking and multiple scenarios	The evaluation of future cash flows, the risk of default and impairment loss should take into account expectations of economic changes that are reasonable. More than one outcome should be considered to ensure that the resulting estimation of impairment is not biased towards a particular expectation of economic growth.	Financial asset carrying values based upon the expectation of future cash flows.	Not applicable.

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Capital and risk management

Credit risk continued

Key IFRS 9 terms and differences to the prior IAS accounting standard and regulatory framework (audited)

Attribute	IFRS 9	IAS 39	Regulatory (CRR)
Loss given default (LGD)	LGD is a current assessment of the amount that will be recovered in the event of default, taking account of future conditions. It may occasionally equate to the regulatory view albeit with conservatism and downturn assumptions generally removed.	Regulatory LGD values were often used for calculating collective and latent provisions; bespoke LGDs were also used.	An estimate of the amount that will not be recovered in the event of default, plus the cost of debt collection activities and the delay in cash recovery. LGD is a downturn based metric, representing a prudent view of recovery in adverse economic conditions.
Exposure at default (EAD)	Expected balance sheet exposure at default. It differs from the regulatory method as follows: It includes the effect of amortisation; and It caps exposure at the contractual limit.	Based on the current drawn balance plus future committed drawdowns.	Models are used to provide estimates of credit facility utilisation at the time of a customer default, recognising that customers may make further drawings on unused credit facilities prior to default or that exposures may increase due to market movements. EAD cannot be lower than the reported balance sheet, but can be reduced by a legally enforceable netting agreement.
Date of initial recognition	The reference date used to assess a significant increase in credit risk is as follows. Term lending: the date the facility became available to the customer. Wholesale revolving products: the date of the last substantive credit review (typically annual) or, if later, the date facility became available to the customer. Retail Cards: the account opening date or, if later, the date the card was subject to a regular three year review or the date of any subsequent limit increases. Current accounts/overdrafts: the account opening date or, if later, the date of initial granting of overdraft facility or of limit increases.	Not applicable for impairment but defined as the date when the entity becomes a party to the contractual provisions of the instrument.	Not applicable.

Modification	A modification occurs when the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in derecognition. A modification requires immediate recognition in the income statement of any impact on the carrying value and effective interest rate (EIR) or examples of modification events include forbearance and distressed restructuring. The financial impact is recognised in the income statement as an impairment release/(loss).	Modification was not separately defined but accounting impact arose as an EIR adjustment on changes that were not derecognition or impairment events.	Not applicable.

Capital and risk management

Market risk

RBS is exposed to non-traded market risk through its banking activities and to traded market risk through its trading activities. Non-traded and traded market risk exposures are managed separately. As a result, each type of market risk is discussed separately. The non-traded market risk section begins below. The traded market risk section begins on page 169.

Pension-related activities also give rise to market risk. Refer to page 172 for more information on risk related to pensions.

Non-traded market risk

Definition

Non-traded market risk is the risk to the value of assets or liabilities outside the trading book, or the risk to income, that arises from changes in market prices such as interest rates, foreign exchange rates and equity prices, or from changes in managed rates.

The following disclosures in this section are audited:

- Internal banking book VaR.
- Foreign exchange risk.
- Equity risk.

Sources of risk

RBS s non-traded market risk exposure is largely managed in line with the following key categories: interest rate risk; credit spread risk; foreign exchange risk; equity risk; and accounting volatility risk.

Interest rate risk

Non-traded interest rate risk (NTIRR) arises from the provision to customers of a range of banking products with differing interest rate characteristics. When aggregated, these products form portfolios of assets and liabilities with varying degrees of sensitivity to changes in market interest rates. Mismatches can give rise to volatility in net interest income as interest rates vary. NTIRR comprises three primary risk types: gap risk, basis risk and option risk.

Credit spread risk

Credit spread risk arises from the potential adverse economic impact of a change in the spread between bond yields and swap rates, where the bond portfolios are accounted at fair value through equity.

Foreign exchange risk

Non-traded foreign exchange risk arises from two main sources:

- Structural foreign exchange risk arises from the capital deployed in foreign subsidiaries, branches and joint arrangements and related currency funding where it differs from sterling.

- Non-trading book foreign exchange risk arises from customer transactions and profits and losses that are in a currency other than the functional currency of the transacting operation.

Equity risk

Non-traded equity risk is the potential variation in income and reserves arising from changes in the values of equity positions. Equity exposures may arise through strategic acquisitions, venture capital investments and certain restructuring arrangements.

Accounting volatility risk

Accounting volatility risk arises when an exposure is accounted for at amortised cost but economically hedged by a derivative that is accounted for at fair value. Although this is not an economic risk, the difference in accounting between the exposure and the hedge creates volatility in the income statement.

Key developments in 2018

- Interest rates rose in 2018 but remained low by historical standards. The UK base rate rose from 0.5% to 0.75% in August 2018. The five-year swap rate was 1.22% at 31 December 2018 compared to 0.98% at 31 December 2017.

- Sterling weakened against the US dollar and slightly against the euro over the year.

- The persistence of low interest rates and weaker sterling partly reflected uncertainty over Brexit.

- Compliance with ring-fencing regulations resulted in the split of non-traded market risk management responsibility for NatWest Holdings and its subsidiaries from non-ring-fenced companies.

- Changes in accounting treatment under IFRS 9, which took effect from 1 January 2018, had an impact on the way certain non-traded market risk exposures are calculated. Some structured loans were recognised at fair value through the profit and loss on transition to IFRS 9. However, this exposure had declined by the end of the year, mainly due to asset disposals.

Risk governance

Responsibility for identifying, measuring, monitoring and controlling market risk arising from non-trading activities lies with the relevant business. Oversight is provided by the independent Risk function.

Risk positions are reported monthly to the Executive Risk Committee and quarterly to the Board Risk Committee, as well as to the Asset & Liability Management Committee (monthly in the case of interest rate, credit spread and accounting volatility risks and quarterly in the case of foreign exchange and equity risks).

Market risk policy statements set out the governance and risk management framework.

Risk appetite

RBS s qualitative appetite is set out in the non-traded market risk appetite statement.

Its quantitative appetite is expressed in terms of value-at-risk (VaR), stressed value-at-risk (SVaR), sensitivity and stress limits, and earnings-at-risk limits. These limits comprise both board risk measures (which are approved by the RBS Board on the recommendation of the Board Risk Committee) and key risk measures, which are approved by the Asset & Liability Management Committee.

The limits are reviewed to reflect changes in risk appetite, business plans, portfolio composition and the market and economic environments.

To ensure approved limits are not breached and that RBS remains within its risk appetite, triggers at RBS and lower levels have been set and are actively managed.

For further information on risk appetite, refer to page 104.

Risk controls

For information on risk controls, refer to page 104.

Risk monitoring and mitigation

Interest rate risk

NTIRR factors are grouped into the following categories:

- Gap risk arises from the timing of rate changes in non-trading book instruments. The extent of gap risk depends on whether changes to the term structure of interest rates occur consistently across the yield curve (parallel risk) or differentially by period (non-parallel risk).

- Basis risk captures the impact of relative changes in interest rates for financial instruments that have similar tenors but are priced using different interest rate indices, or on the same interest rate indices but with different tenors.

- Option risk arises from option derivative positions or from optional elements embedded in assets, liabilities and/or off-balance sheet items, where RBS or its customer can alter the level and timing of their cash flows. Option risk also includes pipeline risk.

Due to the long-term nature of many retail and commercial portfolios and their varied interest rate repricing characteristics and maturities net interest income is likely to vary from period to period, even if interest rates remain the same. New business originated in any period will alter RBS s interest rate sensitivity if the resulting portfolio differs

Capital and risk management

Non-traded market risk continued

from portfolios originated in prior periods, depending on the extent to which exposure has been hedged. To manage exposures within appetite, RBS aggregates its interest rate positions and hedges these externally using cash and derivatives (primarily interest rate swaps).

Credit spread risk

RBS s bond portfolios primarily comprise high-quality securities maintained as a liquidity buffer to ensure RBS can continue to meet its obligations in the event that access to wholesale funding markets is restricted. Additionally other high-quality bond portfolios are held for collateral purposes and to support payment systems.

Credit spread risk is monitored daily through sensitivities and VaR measures. The dealing authorities in place for the bond portfolios further mitigate the risk by imposing constraints by duration, asset class and credit rating. Exposures and limit utilisations are reported to senior management on a daily basis.

Foreign exchange risk

The only material non-traded open currency positions are the structural foreign exchange exposures arising from investments in foreign subsidiaries, branches and associates and their related currency funding. These exposures are assessed and managed to predefined risk appetite levels under delegated authority from the Asset & Liability Management Committee. RBS seeks to limit the potential volatility impact on its CET1 ratio from exchange rate movements by maintaining a structural open currency position. Gains or losses arising from the retranslation of net investments in overseas operations are recognised in equity reserves and reduce the sensitivity of capital ratios to foreign exchange rate movements primarily arising from the retranslation of non-sterling-denominated RWAs. Sensitivity is minimised where, for a given currency, the ratio of the structural open position to RWAs equals the CET1 ratio.

The sensitivity of this ratio to exchange rates is monitored monthly and reported to the Asset & Liability Management Committee at least quarterly. Foreign exchange exposures arising from customer transactions are sold down by businesses on a regular basis in line with RBS policy.

Equity risk

Non-traded equity risk is the potential variation in the income and reserves arising from changes in equity valuations. Any such risk is identified prior to any investments and then mitigated through a framework of controls.

Investments, acquisitions or disposals of a strategic nature are referred to the Acquisitions & Disposals Committee. Once approved by the Acquisitions & Disposals Committee for execution, such transactions are referred for approval to the Board, the Executive Committee, the Chief Executive, the Chief Financial Officer or as otherwise required. Decisions to acquire or hold equity positions in the non-trading book that are not of a strategic nature, such as customer restructurings, are taken by authorised persons with delegated authority under the credit approval framework.

Accounting volatility risk

Accounting volatility can be mitigated through hedge accounting. The profit and loss impact of the derivatives can be mitigated by marking the exposure to market. However, volatility will remain in cases where accounting rules mean that hedge accounting is not an option. Accounting volatility risk is reported to the Asset & Liability Management Committee monthly and capitalised as part of the Internal Capital Adequacy Assessment Process.

Risk measurement

The market risk exposures arising as a result of RBS s retail and commercial banking activities are measured using a combination of value-based metrics (VaR and sensitivities) and earnings-based metrics, as explained in greater detail for each of the exposure types discussed in this section. The following table presents one-day internal banking book VaR at a 99% confidence level, split by risk type.

	2018				2017			
	Average £m	Maximum £m	Minimum £m	Period end £m	Average £m	Maximum £m	Minimum £m	Period end £m
Interest rate	14.4	28.2	7.3	11.6	9.1	15.3	5.6	5.6
Euro	2.1	3.9	1.0	1.0	3.3	4.3	2.3	3.3
Sterling	14.5	26.0	7.9	13.3	6.3	13.8	1.8	2.8
US dollar	4.7	8.7	1.4	8.7	5.5	8.8	2.1	7.7
Other	0.5	0.7	0.3	0.7	1.0	1.1	0.8	0.8
Credit spread	59.7	77.8	49.4	77.8	60.6	82.4	47.4	49.7
Structural foreign exchange rate	13.4	32.7	5.9	13.0	12.4	17.2	9.3	15.4
Pipeline risk (1)	0.6	1.3	0.3	0.4	0.9	1.7	0.2	1.0
Diversification (2)	(24.9)			(20.5)	(19.2)			(17.3)
Total	63.0	82.3	54.9	82.3	63.8	83.1	54.4	54.4

Notes:

(1) Pipeline risk is the risk of loss arising from personal customers owning an option to draw down a loan typically a mortgage at a committed rate, where interest rate changes may result in greater or fewer customers than anticipated taking up the committed offer.

(2) RBS benefits from diversification across various financial instrument types, currencies and markets. The extent of the diversification benefit depends on the correlation between the assets and risk factors in the portfolio at a particular time. The diversification factor is the sum of the VaR on individual risk types less the total portfolio VaR.

Key points (audited)

- On average, non-traded VaR remained broadly unchanged year on year.

- The main component of the VaR is credit spread risk. VaR peaked at year-end, mainly driven by higher volatility in credit spreads due to economic uncertainty that affected the UK Gilts portfolio.

- Interest rate VaR peaked in January driven by the impact of transition to IFRS 9 on interest rate exposure in the structured loan portfolio. It subsequently declined, driven by additional hedging put in place during H1 2018 and asset disposals during H2 2018.

- Structural foreign exchange rate VaR peaked in H1 2018. The VaR measures the residual spot sensitivity of the CET1 ratio to exchange rate movements. CET1 ratio sensitivity to the sterling/US dollar exchange rate increased in May when foreign exchange rate options were exercised to hedge additional US dollar liabilities that were recognised when the agreement in principle with the US Department of Justice was reached.

Capital and risk management

Non-traded market risk continued

Structural hedging

RBS has the benefit of a significant pool of stable, non and low interest-bearing liabilities, principally comprising equity and money transmission accounts. These balances are usually hedged, either by investing directly in longer-term fixed-rate assets (such as fixed-rate mortgages or UK government Gilts) or by using interest rate swaps, which are generally booked as cash flow hedges of floating-rate assets, in order to provide a consistent and predictable revenue stream.

After hedging the net interest rate exposure externally, RBS allocates income to equity or products in structural hedges by reference to the relevant interest rate swap curve. Over time, this approach has provided a basis for stable income attribution to products and interest rate returns. The programme aims to track a time series of medium-term swap rates, but the yield will be affected by changes in product volumes and RBS s capital composition.

The table below presents the incremental income allocation (above three-month LIBOR), total income allocation (including three-month LIBOR), the period end and average notional balances and the total yield (including three-month LIBOR) associated with the structural hedges managed by RBS.

	2018					2017				
	Incremental income £m	Total income £m	Period end notional £bn	Average notional £bn	Total yield %	Incremental income £m	Total income £m	Period end notional £bn	Average notional £bn	Total yield %
Equity structural hedging	469	672	29	29	2.33	628	703	28	28	2.48
Product structural hedging	368	1,104	110	108	1.02	680	1,027	107	101	1.02
Other structural hedges	89	167	22	22	0.77	147	165	21	20	0.83
Total	926	1,943	161	159	1.22	1,455	1,895	156	149	1.27

Equity structural hedges refer to income allocated primarily to equity and reserves. This includes NatWest Markets Plc and NatWest Holdings. Product structural hedges refer to income allocated to customer products, for example current accounts, in NatWest Holdings. Other structural hedges refer to hedges managed by the subsidiaries (Private Banking, Ulster Bank Limited, UBIDAC and RBSI). A significant proportion of Other structural hedges are euro-denominated.

The table below presents the incremental income associated with product structural hedges at segment level. (Restated: see Note 4 for details)

	2018 £m	2017 £m
UK Personal Banking	166	303

Commercial Banking	200	372
Other	2	5
Total	368	680

Key points

- The incremental income from the structural hedge was lower than that in 2017 primarily due to the increase in three-month LIBOR during 2018. The overall yield of the hedge was relatively stable.

- Five-year and ten-year sterling swap rates at 31 December 2018 were 1.22% and 1.35%, respectively. Equity structural hedges amortise over ten years whilst product hedges amortise over five years. Other structural hedges also amortise over five years except a small proportion of RBSI s hedge which amortises over ten years.

- Compliance with ring-fencing regulations during H2 2018 resulted in a split of the equity structural hedge between NatWest Holdings and NatWest Markets. Approximately £6 billion of the equity hedge was allocated to NWM Plc in 2018.

- Additionally, as a result of ring-fencing legislation, RBSI is not able to hedge with NatWest Holdings. Instead of placing hedges with NatWest Holdings Treasury, RBSI now hedges its structural exposure with bonds, primarily UK government Gilts.

Capital and risk management

Non-traded market risk continued

Interest rate risk

NTIRR can be measured from either an economic value-based or earnings-based perspective, or a combination of the two. Value-based approaches measure the change in value of the balance sheet assets and liabilities over a longer timeframe, including all cash flows. Earnings-based approaches measure the potential short-term (generally one-year) impact on the income statement of changes in interest rates.

RBS uses VaR as its value-based approach and sensitivity of net interest income (NII) as its earnings-based approach.

These two approaches provide different yet complementary views of the impact of interest rate risk on the balance sheet at a point in time. The scenarios employed in the NII sensitivity approach incorporate business assumptions and simulated modifications in customer behaviour as interest rates change. In contrast, the VaR approach assumes static underlying positions and therefore does not provide a dynamic measurement of interest rate risk. In addition, while NII sensitivity calculations are measured to a 12-month horizon and thus provide a shorter-term view of the risks on the balance sheet, the VaR approach can identify risks not captured in the sensitivity analysis, in particular the impact of duration and repricing risk on earnings beyond 12 months.

Value-at-risk

VaR is a statistical estimate of the potential change in the market value of a portfolio (and, thus, the impact on the income statement) over a specified time horizon at a given confidence level.

RBS s standard VaR metrics which assume a time horizon of one trading day and a confidence level of 99% are based on interest rate repricing gaps at the reporting date. Daily rate moves are modelled using observations from the last 500 business days. These incorporate customer products plus associated funding and hedging transactions as well as non-financial assets and liabilities. Behavioural assumptions are applied as appropriate.

The non-traded interest rate risk VaR metrics for RBS s retail and commercial banking activities are included in the banking book VaR table on page 165. The VaR captures the risk resulting from mismatches in the repricing dates of assets and liabilities.

It includes any mismatch between structural hedges and stable non and low interest-bearing liabilities such as equity and money transmission accounts as regards their interest rate repricing behavioural profile.

Sensitivity of net interest earnings

Net interest earnings are sensitive to changes in the level of interest rates because changes to coupons on some customer products do not always match changes in market rates of interest or central bank policy rates.

Earnings sensitivity to rate movements is derived from a central forecast over a 12-month period. A simplified scenario is shown below based on the period-end balance sheet (assuming that non-interest rate variables remain constant). Market-implied forward rates are used to generate the base case earnings forecast, which is then subject to interest rate shocks. The variance between the central forecast and the shock gives an indication of underlying sensitivity to interest rate movements.

The sensitivity of net interest earnings table shows the expected impact, over 12 months, to an immediate upward or downward change of 25 and 100 basis points to all interest rates. Yield curves are expected to move in parallel though interest rates are assumed to floor at zero per cent or, for euro rates, at the current negative rate.

The main driver of earnings sensitivity relates to interest rate pass-through assumptions on customer products. The scenario also captures the impact of the reinvestment of maturing structural hedges at higher or lower rates than the base-case earnings sensitivity and mismatches in the repricing dates of loans and deposits.

However, reported sensitivities should not be considered a guide to future performance. They do not capture potential management action in response to sudden changes in the interest rate environment. Actions that could reduce NII sensitivity and mitigate adverse impacts are changes in pricing strategies on customer loans and deposits as well as hedging. Management action may also be targeted at stabilising total income taking into account non-interest income in addition to NII.

	Parallel shifts in yield curve			
	+25 basis points	-25 basis points	+100 basis points	-100 basis points
2018	£m	£m	£m	£m
Euro	29	(3)	114	(1)
Sterling	152	(201)	651	(717)
US dollar	15	(8)	63	(42)
Other	1	2	2	3
Total	197	(210)	830	(757)
2017				
Euro	13	(8)	53	(11)
Sterling	151	(218)	664	(504)
US dollar	14	(13)	58	(49)
Other		(4)		(7)
Total	178	(243)	775	(571)

Key point

- Net interest earnings sensitivity to a 100-basis-point downward shift in yield curves rose in 2018 compared to 2017. In the shock scenarios, rates fell further at 31 December 2018 than at 31 December 2017 before hitting an assumed zero per cent floor on interest rates. This was mainly due to rises in short-term cash rates since December 2017, which increased the impact of the rate shock. This effect was not seen in the 25-basis-point downward shift as most rates remain above zero per cent after the interest rate shock.

Capital and risk management

Non-traded market risk continued

The tables below show the net interest earnings sensitivity on a one-year, two-year and three-year forward-looking basis to a parallel upward or downward shift in interest rates of 25 basis points. The projection is a simplified sensitivity in which the balance sheet is assumed to be constant, with no change in customer behaviour or margin management strategy as a result of rate changes. The benefit of structural hedges increases (or decreases) as maturing hedges are reinvested over the three-year period.

	+25 basis points parallel upward shift			-25 basis points parallel downward shift		
	Year 1	Year 2 (1)	Year 3 (1)	Year 1	Year 2 (1)	Year 3 (1)
2018	£m	£m	£m	£m	£m	£m
Structural hedges	32	98	170	(32)	(98)	(167)
Managed margin (2)	150	171	170	(177)	(189)	(163)
Other	15			(2)		
Total	197	269	340	(210)	(287)	(330)
2017						
Structural hedges	33	100	171	(33)	(99)	(171)
Managed margin (2)	153	170	178	(220)	(137)	(121)
Other	(8)			10		
Total	178	270	349	(243)	(236)	(292)

Notes:

(1) The projections for Year 2 and Year 3 consider only the main drivers of earnings sensitivity, namely structural hedging and margin management.
(2) Primarily current accounts and savings accounts.

Sensitivity of fair value through other comprehensive income (FVOCI) and cash flow hedging reserves to interest rate movements.

RBS holds most of the bonds in its liquidity portfolio at fair value. Valuation changes that are not hedged (or not in effective hedge accounting relationships) are recognised in FVOCI reserves. This is a component of credit spread risk.

Interest rate swaps are used to implement the structural hedging programme and also hedging of some personal and commercial lending portfolios, primarily fixed rate mortgages. Generally these swaps are booked in hedge accounting relationships. Changes in the valuation of swaps that are in effective cash flow hedge accounting relationships are recognised in cash flow hedge reserves.

The table below shows the sensitivity of FVOCI reserves and cash flow hedge reserves to a parallel shift in all rates. In this analysis, interest rates have not been floored at zero. Hedges are assumed to be fully effective. Hedge ineffectiveness would be expected to result in a portion of the reserve gains or losses shown below being recognised in P&L instead of reserves. Hedge ineffectiveness P&L is monitored and the effectiveness of cash flow and fair value hedge relationships are regularly tested in accordance with IFRS requirements. Note that a movement in the FVOCI reserve would have an impact on CET1 capital but a movement in the cash flow hedge reserve would not be expected to do so. Volatility in both reserves affects tangible net asset value.

	+25 basis points	-25 basis points	+100 basis points	-100 basis points
2018	£m	£m	£m	£m
FVOCI reserves	(55)	55	(220)	216
Cash flow hedge reserves	(318)	323	(1,250)	1,315
Total	(373)	378	(1,470)	1,531
2017				
FVOCI reserves	(41)	42	(164)	167
Cash flow hedge reserves	(443)	448	(1,744)	1,819
Total	(484)	490	(1,908)	1,986

Key points

- The sensitivity of the cash flow hedge reserve to interest rate movements fell in 2018. In part this reflected an increase in customer demand for longer fixed rates on mortgage products. Customers increasingly opted to fix mortgage rates for five years. This reduced the requirement for five-year interest rate swaps.

- The increase in FVOCI reserve sensitivity was driven by the increase in the bonds held in liquidity portfolios due to the establishment of the NatWest Markets Plc liquid asset buffer as a result of ring-fencing implementation.

Capital and risk management

Non-traded market risk continued

Foreign exchange risk (audited)

The table below shows structural foreign currency exposures.

2018	Net investments in foreign operations £m	Non-controlling interests (NCI) (1) £m	Net investments in foreign operations excluding NCI £m	Net investment hedges £m	Structural foreign currency exposures pre-economic hedges £m	Economic hedges (2) £m	Residual structural foreign currency exposures £m
US dollar	553		553	(4)	549	(549)	
Euro	6,428	33	6,395	(853)	5,542		5,542
Other non-sterling	2,600	710	1,890	(1,249)	641	(81)	560
Total	9,581	743	8,838	(2,106)	6,732	(630)	6,102
2017							
US dollar	766		766	(14)	752	(752)	
Euro	7,160	61	7,099	(342)	6,757	(2,224)	4,533
Other non-sterling	2,493	645	1,848	(930)	918	(453)	465
Total	10,419	706	9,713	(1,286)	8,427	(3,429)	4,998

Notes:

(1) Non-controlling interests (NCI) represents the structural foreign exchange exposure not attributable to owners equity.

(2) Economic hedges of US dollar net investments in foreign operations represent US dollar equity securities that do not qualify as net investment hedges for accounting purposes. They provide an offset to structural foreign exchange exposures to the extent that there are net assets in overseas operations available. Economic hedges of other currency net investments in foreign operations represent monetary liabilities that are not booked as net investment hedges.

Key points

- The main driver of the reduction in structural foreign currency exposures was lower net investment in eurozone subsidiaries as a result of the 1.5 billion dividend paid by UBI DAC to NatWest Holdings Limited during Q1 2018. The reduction in US dollar exposures reflected the impact of the agreement with the US Department of Justice in relation to RMBS conduct fines.

- Euro economic hedges reduced as a result of the redemption of equity securities.

- Changes in exchange rates affect equity in proportion to structural foreign currency exposures. At 31 December 2018, a 5% strengthening in all foreign currencies against sterling results in a £0.4 billion increase in equity reserves, while a 5% weakening in all foreign currencies against sterling results in a £0.3 billion reduction in equity reserves.

Equity risk (audited)

Equity positions are carried at fair value on the balance sheet based on available market prices where possible. If market prices are not available, fair value is based on appropriate valuation techniques or management estimates.

The table below shows the balance sheet carrying value of non-traded book equity positions.

	2018	2017
	£m	£m
Exchange-traded equity	41	41
Private equity	303	243
Other	87	136
	431	420

The exposures may take the form of (i) equity shares listed on a recognised exchange, (ii) private equity shares defined as unlisted equity shares with no observable market parameters or (iii) other unlisted equity shares.

	2018	2017
	£m	£m
Net realised gains arising from disposals	23	82
Unrealised gains included in Tier 1 or Tier 2 capital	153	60

Note:

(1) Includes gains or losses on FVOCI instruments only.

Capital and risk management

Traded market risk

Definition

Traded market risk is the risk arising from changes in fair value on positions, assets, liabilities or commitments in trading portfolios as a result of fluctuations in market prices.

The following disclosures in this section are audited:

- Traded VaR (1-day 99%)

Sources of risk

Traded market risk mainly arises from RBS s trading activities. These activities provide a range of financing, risk management and investment services to clients including corporations and financial institutions around the world. From a market risk perspective, activities are focused on rates; currencies; securitised products; and traded credit. RBS undertakes transactions in financial instruments including debt securities, as well as securities financing and derivatives.

All material traded market risk resides in NatWest Markets. The key categories are interest rate risk, credit spread risk and foreign currency price risk.

Trading activities may also give rise to counterparty credit risk. For further detail refer to the Credit risk section on page 123.

Key developments in 2018

- Geopolitical risk resulted in periods of market volatility during the year. This mainly related to threats of a trade war between China and the US, elections in Italy and negotiations on a Brexit deal. European interest rates remained at low levels, although the Bank of England and US Federal Reserve continued raising rates.

- Traded VaR fluctuated throughout 2018, reflecting political developments and geopolitical risk, but remained broadly unchanged on an average basis compared to 2017.

Risk governance

Responsibility for identifying, measuring, monitoring and controlling market risk arising from trading activities lies with the relevant trading business. Oversight is provided by the Market Risk function. Traded market risk positions are reported monthly to the Executive Risk Committee and quarterly to the Board Risk Committee. Market risk policy statements set out the governance and risk management framework.

Risk appetite

RBS s qualitative appetite for traded market risk is set out in the traded market risk appetite statement. Quantitative appetite is expressed in terms of exposure limits. The limit framework at RBS level comprises value-at-risk (VaR) and stressed value-at-risk (SVaR). More details on these are provided on the following pages.

The limit framework at trading unit level also comprises additional metrics specific to the market risk exposures within its scope. These additional metrics aim to control various risk dimensions such as product type, exposure size, aged inventory, currency and tenor. For each trading business, a document known as a dealing authority compiles details of all applicable limits and trading restrictions.

The limits are reviewed to reflect changes in risk appetite, business plans, portfolio composition and the market and economic environments. To ensure approved limits are not breached and that RBS remains within its risk appetite, triggers at RBS and lower levels have been set such that if exposures exceed a specified level, action plans are developed by the relevant business and the Market Risk function and implemented.

For more detail on risk appetite, refer to page 104.

Risk controls

For information on risk controls, refer to page 104.

Risk monitoring and mitigation

Traded market risk is identified and assessed by gathering, analysing, monitoring and reporting market risk information at desk, business, franchise and RBS-wide levels. Industry expertise, continued system developments and techniques such as stress testing are also used to enhance the effectiveness of the identification and assessment of all material market risks.

Traded market risk exposures are monitored against limits and analysed daily by market risk reporting and control functions. A daily report summarising the position of exposures against limits at RBS, franchise, business and desk levels is provided to senior management and market risk managers across the function. Limit reporting is supplemented with regulatory capital and stress testing information as well as ad hoc reporting.

A risk review of trading businesses is undertaken weekly with senior risk and front office staff. This includes a review of profit and loss drivers, notable position concentrations and other positions of concern.

Business profit and loss performance is monitored automatically through loss triggers which, if breached, require a remedial action plan to be agreed between the Market Risk function and the business. The loss triggers are set using both a fall-from-peak approach and an absolute loss level. In addition, regular updates on traded market risk positions are provided to the Executive Risk Committee and Board Risk Committee.

Risk measurement (audited)

RBS uses VaR, SVaR and the incremental risk charge to measure traded market risk. Risks that are not adequately captured by VaR or SVaR are captured by the Risks Not In VaR (RNIV) framework to ensure that RBS is adequately capitalised for market risk. In addition, stress testing is used to identify any vulnerabilities and potential losses in excess of VaR and SVaR.

The key inputs into these measurement methods are market data and risk factor sensitivities. Sensitivities refer to the changes in trade or portfolio value that result from small changes in market parameters that are subject to the market risk limit framework. Revaluation ladders are used in place of sensitivities to capture the impact of large moves in risk factors or the joint impact of two risk factors.

These methods have been designed to capture correlation effects and allow RBS to form an aggregated view of its traded market risk across risk types, markets and business lines while also taking into account the characteristics of each risk type.

Value-at-risk

For internal risk management purposes, VaR assumes a time horizon of one trading day and a confidence level of 99%.

The internal VaR model which captures all trading book positions including those products approved by the regulator is based on a historical simulation, utilising market data from the previous 500 days on an equally-weighted basis.

The model also captures the potential impact of interest rate risk; credit spread risk; foreign currency price risk; equity price risk; and commodity price risk.

When simulating potential movements in such risk factors, a combination of absolute, relative and rescaled returns is used.

Testing of the performance and adequacy of the VaR model is done on a regular basis through the following processes:

- Back-testing Internal and regulatory back-testing is conducted on a daily basis. (For information on internal back-testing, refer to page 171.)

- Ongoing model validation VaR model performance is assessed both regularly and on an ad-hoc basis if market conditions or portfolio profile change significantly.

- Model Risk Management review As part of the model lifecycle, all risk models (including the VaR model) are independently reviewed to ensure the model is still fit for purpose given current market conditions and portfolio profile.

Capital and risk management

Traded market risk continued

One-day 99% traded internal VaR

Traded VaR (1-day 99%)

The table below shows one-day 99% internal VaR for RBS s trading portfolios, split by exposure type.

	2018				2017			
	Average £m	Maximum £m	Minimum £m	Period end £m	Average £m	Maximum £m	Minimum £m	Period end £m
Interest rate	14.3	27.3	9.2	13.0	14.1	24.5	8.8	15.3
Credit spread	11.0	24.2	6.9	8.2	12.1	19.4	8.8	16.7
Currency	3.1	7.6	1.4	5.3	4.9	10.0	2.3	3.5
Equity	0.8	1.6	0.3	0.8	1.2	2.1	0.4	0.4

Commodity	0.3	1.0	0.1	0.1	0.4	1.3		0.2
Diversification (1)	(10.5)			(8.8)	(12.8)			(15.3)
Total	19.0	35.6	11.7	18.6	19.9	29.5	13.2	20.8

Note:

(1) RBS benefits from diversification since it reduces risk by allocating positions across various financial instrument types, currencies and markets. The extent of the diversification benefit depends on the correlation between the assets and risk factors in the portfolio at a particular time. The diversification factor is the sum of the VaR on individual risk types less the total portfolio VaR.

Key points

- Although traded VaR fluctuated throughout 2018 as explained earlier, it remained broadly unchanged year-on-year on both an average and period-end basis.

- The peaks in January, May and July were largely related to bond syndication activity and, in the case of January, long euro rates.

Capital and risk management

Traded market risk continued

VaR back-testing

The main approach employed to assess the VaR model s ongoing performance is back-testing, which counts the number of days when a loss exceeds the corresponding daily VaR estimate, measured at a 99% confidence level.

Two types of profit and loss (P&L) are used in back-testing comparisons: Actual P&L and Hypothetical (Hypo) P&L.

The Actual P&L for a particular business day is the firm s actual P&L in respect of trading activities, including intraday activities, adjusted by stripping out fees and commissions, brokerage, and additions to and releases from reserves not directly related to market risk.

The Hypo P&L reflects the firm s Actual P&L excluding any intra-day activities.

A portfolio is said to produce a back-testing exception when the Actual or Hypo P&L exceeds the VaR level on a given day. Such an event may be caused by a large market movement or may highlight issues such as missing risk factors or inappropriate time series. Any such issues identified are analysed and addressed through appropriate remediation or development action. Both Actual and Hypo back-testing exceptions are monitored.

The table below shows internal back-testing exceptions for the 250-business-day period to 31 December 2018 for one-day 99% traded internal VaR compared with Actual and Hypo P&L for the major NatWest Markets businesses.

	Back-testing exceptions	
	Actual	Hypo
Rates	4	8
Currencies		4
Credit		

Key points

- Statistically RBS would expect to see back-testing exceptions 1% of the time over the 250-day period.
- The exceptions in the Rates business were mainly driven by the increased volatility connected with large market movements due to political uncertainty in Italy and Spain.

- The exceptions in the Currencies business were mainly due to market movements.

Stressed VaR (SVaR)

As with VaR, the SVaR methodology produces estimates of the potential change in the market value of a portfolio, over a specified time horizon, at a given confidence level. SVaR is a VaR-based measure using historical data from a one-year period of stressed market conditions.

A simulation of 99% VaR is run on the current portfolio for each 250-day period from 2005 to the current VaR date, moving forward one day at a time. The SVaR is the worst VaR outcome of the simulated results.

This is in contrast with VaR, which is based on a rolling 500-day historical data set. A time horizon of ten trading days is assumed with a confidence level of 99%.

The internal traded SVaR model captures all trading book positions.

	Period-end 2018 £m	Period-end 2017 £m
10-day 99% traded internal SVaR	161	172

Key point

- Traded SVaR remained broadly unchanged.

Risks not in VaR (RNIVs)

The RNIV framework is used to identify and quantify market risks that are not fully captured by the internal VaR and SVaR models.

RNIV calculations form an integral part of ongoing model and data improvement efforts to capture all market risks in scope for model approval in VaR and SVaR.

For quantitative disclosures on RNIVs, refer to the Market Risk section of the Pillar 3 Report.

Stress testing

For information on stress testing, refer to page 105.

Incremental risk charge (IRC)

The IRC model quantifies the impact of rating migration and default events on the market value of instruments with embedded credit risk (in particular, bonds and credit default swaps) held in the trading book. It further captures basis risk between different instruments, maturities and reference entities.

Model validation

RBS uses a variety of models to manage and measure market risk. These include pricing models (used for valuation of positions) and risk models (for risk measurement and capital calculation purposes). They are developed and approved in NatWest Markets, with material models subject to independent review by Model Risk Management. For further detail on the independent model validation carried out by Model Risk Management refer to page 105. Information relating to pricing and market risk models is presented below.

Pricing models

Pricing models are developed by a dedicated first line team, in conjunction with the trading desk. The models are used to value positions for which prices are not directly observable as well as for the risk management of the portfolio. Any pricing models that are used as the basis for valuing portfolios and records are subject to approval and oversight by asset-level modelled product review committees. These committees comprise representatives of the trading, finance, market risk, model development and model review functions. Approval requires review and approval by these stakeholders as well as Model Risk Management.

The review process includes the following steps:

- The committees prioritise models for review by Model Risk Management, considering the materiality of the risk booked against the model and an assessment of the degree of model risk, which is the valuation uncertainty arising from the choice of modelling assumptions.
- Model Risk Management quantifies the model risk, which may include comparing the model outputs with those of alternative models developed by Model Risk Management.
- The sensitivities derived from the pricing models are validated.
- The conclusions of the review are used to inform risk limits and by the Finance function to inform model reserves.

Risk models

All model changes are approved through model governance committees at franchise level. Changes to existing models are subject to Model Risk Management review. RBS follows regulatory guidance for assessing the materiality of extensions and changes to the internal model approach for market risk. In addition to Model Risk Management s independent oversight which provides additional assurance that RBS holds appropriate capital for the market risk to which it is exposed the model testing team monitors the model performance for market risk through back-testing and other processes.

Capital and risk management

Pension risk

Definition

Pension obligation risk is the risk to RBS caused by its contractual or other liabilities to, or with respect to, a pension scheme (whether established for its employees or those of a related company or otherwise). It is also the risk that RBS will make payments or other contributions to, or with respect to, a pension scheme because of a moral obligation or because RBS considers that it needs to do so for some other reason.

Sources of risk

RBS has exposure to pension risk through its defined benefit schemes worldwide. The Main section of The Royal Bank of Scotland Group Pension Fund (the Main section) is the largest source of pension risk with £43.8 billion of assets and £35.5 of liabilities at 31 December 2018 (2017 £44.7 billion assets and £37.9 billion liabilities). Further detail on RBS s pension obligations, including sensitivities to the main risk factors, can be found in Note 5 on the consolidated accounts.

Pension scheme liabilities vary with changes in long-term interest rates and inflation as well as with pensionable salaries, the longevity of scheme members and legislation. Pension scheme assets vary with changes in interest rates, inflation expectations, credit spreads, exchange rates, and equity and property prices. RBS is exposed to the risk that the schemes assets, together with future returns and additional future contributions, are insufficient to meet liabilities as they fall due. In such circumstances, RBS could be obliged (or might choose) to make additional contributions to the schemes, or be required to hold additional capital to mitigate this risk.

Key developments in 2018

- A Memorandum of Understanding between RBS and the Trustee of the Main section was reached in April 2018, which enabled RBS to bring the pension scheme into alignment with ring-fencing rules and reduce exposure to pension risk.

- RBS made a £2 billion contribution to the Main section in H2 2018 and it was agreed this could be followed by up to a further £1.5 billion of dividend linked contributions to be paid from 2020, capped at £500 million per year.

- The contribution to the scheme facilitated a reduction in the risk profile of the fund, principally the sale of approximately £6 billion of quoted equity exposure and the purchase of further interest rate and inflation hedging.

Risk governance

The Pension Committee is chaired by the RBS Chief Financial Officer. It receives its authority from the Group Executive Committee and formulates RBS s view of pension risk. The Pension Committee is a key component of RBS s approach to managing pension risk and it reviews and monitors risk management, asset strategy and financing issues on behalf of RBS. It also considers investment strategy proposals from the Trustee.

For further information on Risk governance, refer to page 103.

Risk appetite

RBS maintains an independent view of the risk inherent in its pension funds. RBS has an annually reviewed pension risk appetite statement incorporating defined metrics against which risk is measured. RBS undertakes regular pension risk monitoring and reporting to the Board, the Board Risk Committee and the Pension Committee on the material pension schemes that RBS has an obligation to support.

Risk controls

A pension risk management framework is in place to provide formal controls for pension risk reporting, modelling, governance and stress testing. A pension risk policy, which sits within the RBS policy framework, is also in place and is subject to associated framework controls.

Risk monitoring and measurement

Pension risk reports are submitted to the Executive Risk Committee and the Board Risk Committee four times a year in the Risk Management Quarterly Report.

RBS also undertakes stress tests and scenario analyses on its material defined benefit pension schemes each year. These tests are also used to satisfy the requests of regulatory bodies such as the Bank of England. The stress testing framework includes pension risk capital calculations for the purposes of the Internal Capital Adequacy Assessment Process as well as additional stress tests for a number of internal management purposes.

The results of the stress tests and their consequential impact on RBS s balance sheet, income statement and capital position are incorporated into the overall RBS stress test results.

Risk mitigation

The trustee has taken measures to mitigate inflation and interest rate risks, both by investing in suitable financial assets and by entering into inflation and interest rate swaps. The Main section also uses derivatives to manage the allocation of the portfolio to different asset classes and to manage risk within asset classes. The contribution made to the Main section also facilitated a £6 billion reduction in quoted equity exposure and an increase in interest rates and inflation hedging in 2018.

Compliance & conduct risk

Definition

Compliance risk is the risk that the behaviour of RBS towards customers fails to comply with laws, regulations, rules, standards and codes of conduct. Such a failure may lead to breaches of regulatory requirements, organisational standards or customer expectations and could result in legal or regulatory sanctions, material financial loss or reputational damage.

Conduct risk is the risk that the conduct of RBS and its subsidiaries and its staff towards customers or in the markets in which it operates leads to unfair or inappropriate customer outcomes and results in reputational damage, financial loss or both.

Sources of risk

Compliance and conduct risks exist across all stages of RBS s relationships with its customers and arise from a variety of activities including product design, marketing and sales, complaint handling, staff training, and handling of confidential insider information. As set out in Note 27 on the consolidated accounts, RBS and certain members of staff are party to legal proceedings and are subject to investigation and other regulatory action in the UK, the US and other jurisdictions.

Key developments in 2018

- An enhanced compliance and conduct risk framework was developed, setting minimum standards for the management and measurement of compliance and conduct risks across RBS.
- Enhanced product monitoring and reporting was introduced.
- Controls, systems and processes were revised to ensure compliance with the UK s ring-fencing rules.
- PPI remediation continued in advance of the FCA s August 2019 deadline for claims (refer to Note 20 on the consolidated accounts).
- Work to address legacy GRG complaints continued. The process closed to new complaints in the UK on 22 October 2018.
- Product and pricing continued to be simplified for new and existing customers.

Risk governance

RBS defines appropriate standards of compliance and conduct and ensures adherence to those standards through its risk management framework.

Capital and risk management

Compliance & conduct risk continued

Risk appetite

Risk appetite for compliance and conduct risks is set at Board level. RBS Risk appetite statements articulate the levels of risk that legal entities, franchises and functions work within when pursuing their strategic objectives and business plans.

Risk controls

RBS operates a range of controls to ensure its business is conducted in accordance with legal and regulatory requirements, as well as delivering good customer outcomes. A suite of policies addressing compliance and conduct risks set appropriate standards across RBS. Examples of these include the Complaints Management Policy, Client Assets & Money Policy, and Product Lifecycle Policy as well as policies relating to customers in vulnerable situations, cross-border activities and market abuse. Continuous monitoring and targeted assurance is undertaken, as appropriate.

Risk monitoring and measurement

Compliance and conduct risks are measured and managed through continuous assessment and reporting to RBS s senior risk committees and at Board level.

The compliance and conduct risk framework facilitates the consistent monitoring and measurement of compliance with laws and regulations and the delivery of consistently good customer outcomes.

The first line of defence is responsible for effective risk identification, reporting and monitoring, with oversight, challenge and review by the second line. Compliance and conduct risk management is also integrated into RBS s strategic planning cycle.

Risk mitigation

Activity to mitigate the most-material compliance and conduct risks is carried out across RBS with specific areas of focus in the customer-facing franchises and legal entities. Examples of mitigation include consideration of customer needs in business and product planning, targeted training, complaints management, as well as independent assurance activity. Internal policies help support a strong customer focus across RBS. Independent assessments of compliance with applicable regulations are also carried out at a legal entity level.

Financial crime

Definition

Financial crime risk is the risk presented by criminal activity in the form of money laundering, terrorist financing, bribery and corruption, sanctions and tax evasion. It does not include fraud risk management.

Sources of risk

Financial crime risk may be presented if RBS s employees, customers or third parties undertake or facilitate financial crime, or if RBS s products or services are used to facilitate such crime. Financial crime risk is an inherent risk across all of RBS s lines of business.

Key developments in 2018

- In March 2018, the Federal Reserve Board terminated a Cease & Desist Order originally imposed in July 2011 for financial crime compliance weaknesses identified across RBS s US businesses and concerns about the level of oversight that the RBS Board of Directors had over large and complex US operations. The termination of the Order followed a multi-year programme of work to establish an enhanced governance and oversight framework, risk management programme and compliance programme.

- In October 2018, the Federal Reserve Board terminated a Cease & Desist Order originally imposed in December 2013. The Order, which related to RBS Group and RBS plc s historical compliance with Office of Foreign Assets Control (OFAC) economic sanctions regulations, was terminated following a multi-year programme of work to establish a robust, sustainable OFAC Sanctions compliance framework.

- While the financial crime governance framework was strengthened during 2018 along with the introduction of enhanced control effectiveness assurance processes, enhancements to existing risk assessment models, the introduction of a new Anti-Tax Evasion risk assessment; and improved monitoring controls and enhanced investigation processes the journey of improvement continues.

Risk governance

Financial crime risk is principally governed through the Financial Crime Risk Executive Committee, which is chaired by the Chief Financial Crime Officer. The committee reviews and, where appropriate, escalates material risks and issues to the Group Executive Risk Committee and the Group Board Risk Committee.

Risk appetite

RBS has no appetite to operate in an environment where systems and controls do not enable RBS to identify, assess, monitor, manage and mitigate financial crime risk. RBS s systems and controls must be comprehensive and proportionate to the nature, scale and complexity of its businesses. RBS has no tolerance to systematically or repeatedly breach relevant financial crime regulations and laws.

Risk controls

RBS operates a framework of preventative and detective controls designed to ensure RBS mitigates the risk that it could facilitate financial crime. These controls are supported by a suite of policies, procedures and detailed instructions to ensure they operate effectively.

Risk monitoring and measurement

Financial crime risks are identified and reported through continuous risk management and regular monthly reporting to RBS s senior risk committees and the Board. Quantitative and qualitative data is reviewed and assessed to measure whether financial crime risk is within the Group s risk appetite.

Risk mitigation

Through the financial crime framework, RBS employs relevant policies, systems, processes and controls to mitigate financial crime risk. This would include the use of dedicated screening and monitoring controls to identify people, organisations, transactions and behaviours which might require further investigation or other actions. RBS ensures that centralised expertise is available to detect and disrupt threats to the Group and its customers. Intelligence is shared with law enforcement, regulators and government bodies to strengthen national and international defences against those who would misuse the financial system for criminal motives.

Operational risk

Definition

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or external events. It arises from day-to-day operations and is relevant to every aspect of the business.

Sources of risk

Operational risk may arise from a failure to manage operations, systems, transactions and assets appropriately. This can take the form of human error, an inability to deliver change adequately or on time, the non-availability of technology services, or the loss of customer data. Fraud and theft as well as the increasing threat of cyber attacks are sources of operational risk, as is the impact of natural and man-made disasters. Operational risk can also arise from a failure to account for changes in law or regulations or to take appropriate measures to protect assets.

Capital and risk management

Operational risk continued

Key developments in 2018

- Risk provided oversight of several bank-wide programmes including the Transformation portfolio, structural reform, European Commission (EC) State Aid obligations and Brexit preparations.

- Key corporate structural reform milestones were delivered, including the implementation of the Financial Services Markets Act Part VII and migration activities to separate the ring-fence bank from the non ring-fenced bank.

- RBS is well positioned to deliver the activities required to support the Business Banking Switch Scheme that is due to commence in 2019, as part of the Group s final EC State Aid obligation.

- RBS has established an Innovation Risk Oversight team to provide bank-wide oversight of its innovation portfolio to help deliver safely and at pace.

- RBS continued to review its well established incident management and coordination procedures to manage the persistent and evolving nature of information and cyber security risks.

- Internal security improvement programmes and controls were developed and strengthened to protect RBS and its customers. RBS uses proactive threat management and intelligence processes to identify, manage and mitigate credible threats.

- RBS continued to reduce and simplify its technology estate through strategic investment and Technology transformation initiatives to limit opportunities for hackers and fraudsters. Improvements in capability were also made to the Security Operations Centre, strengthening controls to prevent data leakage, enhance malware defences and management of user access to key systems.

- The number of critical customer impacting incidents that RBS experiences continues to reduce year-on-year. There were 17 such incidents in 2018 compared to 20 in 2017.

- Internal training programmes ensure all employees are aware of the threats facing RBS and remain vigilant to unauthorised attempts to access systems and data.

Risk governance

A strong operational risk management function is vital to support RBS s ambitions to serve its customers better. Improved management of operational risk against defined appetite directly supports the strategic risk objective of improving stakeholder confidence and is vital for stability and reputational integrity.

The Operational Risk function, which is the second line of defence, delivers a robust operational risk management framework and culture across RBS.

The Operational Risk function is responsible for the execution and continuous improvement of the operational risk management framework.

The Operational Risk Executive Committee (OREC) is responsible for reviewing operational risk exposure; identifying and assessing both current and emerging material operational risks; reviewing and monitoring the operational risk profile; and reviewing and approving material operational risk policy changes.

Risk appetite

Operational risk appetite supports effective management of material operational risks. It expresses the level and types of operational risk RBS is willing to accept to achieve its strategic objectives and business plans.

The Group-wide operational risk appetite statement encompasses the full range of operational risks faced by its legal entities, franchises and functions. A subset of the most material risk appetite measures are defined as board risk measures, which are those that, should the limit be breached, would impact on the ability to achieve business plans and threaten stakeholder confidence.

Risk controls

The Control Environment Certification (CEC) process is a half yearly self-assessment by the CEOs of RBS s franchises and business units, as well as the heads of the support and control functions, providing a view on the adequacy and effectiveness of the internal control environment in a consistent and comparable manner. In line with ring-fencing requirements, from H2 2018 certificates were also produced for the following legal entities: NatWest Holdings Limited; NatWest Markets Plc; The Royal Bank of Scotland International Limited; Ulster Bank Ireland DAC; and Coutts and Co.

CEC covers material risks and the underlying key controls, including financial, operational and compliance controls, as well as supporting risk management frameworks. The CEC outcomes, including forward-looking assessments for the next two half-yearly cycles and progress on control environment improvements, are reported to the Board, Group Audit Committee and Board Risk Committee. They are also shared with external auditors.

The CEC process helps to ensure compliance with the RBS Policy Framework, Sarbanes-Oxley 404 requirements concerning internal control over financial reporting (as referenced in the Compliance report on page 95), and certain requirements of the UK Corporate Governance Code.

Risk monitoring and measurement

Risk and control assessments are used across all business areas and support functions to identify and assess material operational and conduct risks and key controls. All risks and controls are mapped to RBS s Risk Directory. Risk assessments are refreshed at least annually to ensure they remain relevant and capture any emerging risks, with associated trigger processes to ensure risks are reassessed at key periods of change.

The process is designed to confirm that risks are effectively managed and prioritised in line with risk appetite. Controls are tested at the appropriate frequency to verify that they remain fit-for-purpose and operate effectively.

RBS uses the standardised approach to calculate its Pillar 1 operational risk capital requirement. This is based on multiplying three years average historical gross income by coefficients set by the regulator based on business line. As part of the wider Internal Capital Adequacy Assessment Process an operational risk economic capital model is used to assess Pillar 2A, which is a risk-sensitive add-on to Pillar 1.The model uses historical loss data (internal and external) and forward-looking scenario analysis that is provided by Operational Risk to provide a risk-sensitive view of RBS s P2A capital requirement.

Scenario analysis is used to assess how extreme but plausible operational risks will affect RBS. It provides a forward-looking basis for evaluating and managing operational risk exposures.

Refer to the Capital, liquidity and funding risk section for operational risk capital requirement figures.

Event and loss data management

The operational risk event and loss data management process ensures RBS captures and records operational risk financial and non financial events that meet defined criteria. Loss data is used for regulatory and industry reporting and is included in capital modelling when calculating economic capital for operational risk. The most serious events are escalated in a simple, standardised process to all senior management, by way of a Group Notifiable Event Process.

Capital and risk management

Operational risk continued

All financial impacts associated with an operational risk event are reported against the date they were recorded in RBS s financial accounts. A single event can result in multiple losses (or recoveries) that may take time to crystallise. Losses and recoveries with a financial accounting date in 2018 may relate to events that occurred, or were identified in, prior years. RBS purchases insurance against specific losses and to comply with statutory or contractual requirements.

Percentage and value of events

At 31 December 2018, events aligned to the clients, products and business practices event category accounted for 98% of RBS s operational risk losses (compared to 93% in 2017). The increase reflected new or additional conduct-related provisions recorded during 2018, most notably the US Department of Justice mortgage-backed securities-related settlement.

	Value of events				Volume of events (1)	
	£m		Proportion		Proportion	
	2018	2017	2018	2017	2018	2017
Fraud	19	28	1%	2%	74%	74%
Clients, products and business practices (2)	1,552	1,264	98%	93%	15%	12%
Execution, delivery and process management	12	58	1%	4%	10%	9%
Employment practices and workplace safety	1	5		1%	1%	5%
	1,584	1,355	100%	100%	100%	100%

Notes:

(1) The calculation in the table above is based on the volume and value of events (the proportion and cost of operational risk events to RBS) where the associated loss is more than or equal to £10,000.

(2) 2017 losses have been restated from £732 million following finalisation of material MBS-related settlements.

Operational resilience

RBS manages and monitors operational resilience through its risk and control assessments methodology. As challenges to operational resilience become more demanding, given a hostile cyber environment and a greater focus on serving customers through digital platforms, RBS is working with supervisory authorities in the UK to ensure the provision of its products and services can be maintained regardless of the cause of disruption.

This is underpinned by setting, monitoring and testing tolerances for key business services, which define the amount of disruption that could be tolerated.

Risk mitigation

Risks are mitigated by applying key preventative and detective controls, an integral step in the risk assessment methodology which determines residual risk exposure. Control owners are accountable for the design, execution, performance and maintenance of key controls. Key controls are regularly assessed for adequacy and tested for effectiveness. The results are monitored and, where a material change in performance is identified, the associated risk is re-evaluated.

Business risk

Definition

Business risk is the risk that RBS does not have a strategy that is sufficiently well defined to provide clarity on its long-term ambitions to key internal and external stakeholders, or that it is not able to execute upon its chosen strategy as communicated to the market, regulators and other key stakeholders. The risk is that RBS does not deliver its expected business performance which could give rise to a deterioration in stakeholder trust and confidence and/or a breach of regulatory thresholds. RBS may not be able to execute its chosen strategy if there are material changes to RBS s internal or external operating environment.

Sources of risk

Business risk arises as a result of RBS s exposure to the macro-economy (including economic and political factors), the competitive environment, regulatory and technological changes. In addition, internal factors such as the ability to deliver complex change, volatility in sales volumes, input costs, and other operational risks affect RBS s ability to execute its chosen strategic business plan as intended and thus contribute to business risk.

Key developments in 2018

- As part of its requirement by UK law to separate its everyday banking services from its investment banking by 1 January 2019 known as ring-fencing RBS made a number of changes to the way its business was structured. Certain Personal Banking businesses and Commercial Banking businesses of The Royal Bank of Scotland plc transferred to Adam & Company PLC and National Westminster Bank Plc. The role of issuer under the covered bond programme transferred to National Westminster Bank Plc. Adam & Company PLC was renamed The Royal Bank of Scotland plc , and The Royal Bank of Scotland plc was renamed NatWest Markets Plc . The Royal Bank of Scotland plc superseded the prior issuer (former RBS plc) in respect of banknotes.

- RBS also restructured the NatWest Markets Plc (former RBS plc) capital structure. The shares in NatWest Holdings Limited, which owns the ring-fenced sub-group, were distributed to RBS. This separated the ring-fenced sub-group from the non-ring-fenced entities, as required by ring-fencing legislation. RBS also transferred the customer interest rate and foreign exchange derivatives business of National Westminster Bank Plc to NatWest Markets Plc.

- RBS reached a civil settlement in principle with the US Department of Justice in relation its investigation into RBS s issuance and underwriting of US Residential Mortgage Backed Securities (RMBS) between 2005 and 2007, resulting in a £1.0 billion additional provision.

- UK Government Investments Limited announced the successful completion of the disposal of part of HM Treasury s shareholding in The Royal Bank of Scotland Group plc, representing approximately 7.7% of the ordinary share capital of the Group. HM Treasury s shareholding in RBS now represents 62.3% of the Group s ordinary share capital.

- On 17 April 2018 RBS agreed a Memorandum of Understanding (MoU) with the Trustees of the RBS Group Pension Fund in connection with the requirements of ring-fencing. NatWest Markets Plc cannot continue to be a participant in the Main section and separate arrangements are required for its employees. Under the MoU NatWest Bank made a contribution of £2 billion on 9 October 2018 to strengthen funding of the Main section in recognition of the changes in covenant.

Capital and risk management

Business risk continued

- RBS declared an interim ordinary dividend of 2 pence per share the first since September 2008.

Risk governance

The Board has ultimate responsibility for business risk and for approving strategic plans, initiatives and changes to strategic direction.

RBS s strategic planning process is managed by Strategy and Corporate Development. The Risk and Finance functions are key contributors to strategic planning.

Responsibility for the day-to-day management of business risk lies primarily with the franchises, with oversight by the Finance function. The franchises are responsible for delivery of their business plans and the management of such factors as pricing, sales volumes, marketing expenditure and other factors that can introduce volatility into earnings.

Risk appetite

Risk Appetite defines the level and types of risk it is willing to accept in order to achieve its strategic objectives and business plans. RBS articulates its appetite for business risk through the implementation of qualitative risk appetite statements and quantitative risk measures at franchise and function level. These statements and measures help determine the level and types of business risk RBS is willing to accept.

Risk controls

For information on risk controls, refer to page 104.

Risk monitoring and measurement

Business risk is identified and managed at the product and transaction level. Estimated revenue, costs and capital are key considerations in the design of any new product or in any new investment decision. Business risk is reported, assessed and challenged at every governance level within the organisation. Each franchise monitors its financial performance relative to plans and reports this on a regular basis to the finance directors of each franchise.

Risk mitigation

RBS operates a monthly rolling forecasting process to identify projected changes in, or risks to, key financial metrics, and ensures appropriate actions are taken.

Reputational risk

Definition

Reputational risk is the risk to RBS s public image from a failure to meet stakeholders expectations in relation to performance, conduct or business profile. Stakeholders include customers, investors, employees, suppliers, government, regulators, special interest and consumer groups, media and the general public.

Sources of risk

Reputational risk can arise from the conduct of employees; customer activities and the sectors and countries in which they operate; provision of products and transactions; as well as operations and infrastructure.

Key developments in 2018

- Metrics were reviewed and enhanced to help measure reputational risk across the Group.
- Risk appetite positions for countries and sectors identified as presenting heightened reputational risk continued to be reviewed and strengthened.

Risk governance

A reputational risk policy supports reputational risk management across RBS. Reputational risk committees in PB, CPB, RBSI, Ulster Bank RoI and NatWest Markets review relevant issues at an individual franchise or entity level, while the Group Reputational Risk Committee which has delegated authority from the Executive Risk Committee opines on cases, issues, sectors and themes that represent a material reputational risk to the Group. The Board Risk Committee oversees the identification and reporting of reputational risk. The Sustainable Banking Committee has a specific focus on environmental, social and ethical issues.

Risk appetite

RBS manages and articulates its appetite for reputational risk through a qualitative reputational risk appetite statement and quantitative measures. RBS seeks a continued improvement in the identification, assessment and management of customers, transactions, products and issues that present a material reputational risk.

Risk controls

For information on risk controls, refer to page 104.

Risk monitoring and measurement

Primary reputational risk measures are in place to assess internal activity relating to the management of reputational risk, including training. A number of secondary risk measures including measures also used in the management of operational, conduct and financial risks are used to assess relevant external factors. Quarterly reports on performance against these measures are provided to the Executive Risk Committee and Board Risk Committee.

Risk mitigation

Reputational risk is mitigated through the policy and governance framework, with ongoing staff training to ensure early identification, assessment and escalation of material issues.

The most material threats to RBS s reputation continued to originate from historical and more recent conduct issues. As a result, RBS has been the subject of investigations and reviews by a number of regulators and governmental authorities, some of which have resulted in fines, settlements and public censure. Refer to the Litigation, investigations and reviews section of Note 27 on the consolidated accounts.

Financial statements

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Financial statements

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of The Royal Bank of Scotland Group plc

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of The Royal Bank of Scotland Group plc (the Group) as of 31 December 2018 and 2017, and the related consolidated statements of income, comprehensive income, changes in equity and cash flows for each of the three years in the period ended 31 December 2018, the related Accounting policies and Notes 1 to 36, and the information identified as audited in the Annual Report on Remuneration in the Directors Remuneration Report and in the Capital and risk management section (collectively referred to as the financial statements). In our opinion, the financial statements present fairly, in all material respects, the consolidated financial position of the Group at 31 December 2018 and 2017 and the consolidated results of its operations and its cash flows for each of the three years in the period ended 31 December 2018, in conformity with International Financial Reporting Standards (IFRS) as adopted for use in the European Union and IFRS as issued by the International Accounting Standards Board.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Group s internal control over financial reporting as of 31 December 2018, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework), and our report dated 14 February 2019 expressed an unqualified opinion thereon.

Adoption of International Financial Reporting Standard 9 Financial Instruments

As discussed in section 1. Presentation of accounts of the Accounting policies to the financial statements, the Group changed its method of accounting for the classification, measurement and impairment of financial instruments in 2018 due to the adoption of IFRS 9 *Financial Instruments.*

Basis for Opinion

These financial statements are the responsibility of the Group s management. Our responsibility is to express an opinion on the Group s financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Group in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note 4 to the consolidated financial statements, the accompanying 2018, 2017 and 2016 consolidated financial statements have been represented to reflect a change in reportable segments.

/s/ Ernst & Young LLP

We have served as the Group s auditors since 2016.

London, United Kingdom

14 February 2019 (30 April 2019 as to the representation for the change in reportable segments as disclosed in Note 4)

Financial statements

To the Shareholders and the Board of Directors of The Royal Bank of Scotland Group plc

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of The Royal Bank of Scotland Group plc (the Group) as of 31 December 2018 and 2017, and the related consolidated statements of income, comprehensive income, changes in equity and cash flows for each of the three years in the period ended 31 December 2018, the related Accounting policies and Notes 1 to 36, and the information identified as audited in the Annual Report on Remuneration in the Directors Remuneration Report and in the Capital and risk management section (collectively referred to as the financial statements). In our opinion, the financial statements present fairly, in all material respects, the consolidated financial position of the Group at 31 December 2018 and 2017 and the consolidated results of its operations and its cash flows for each of the three years in the period ended 31 December 2018, in conformity with International Financial Reporting Standards (IFRS) as adopted for use in the European Union and IFRS as issued by the International Accounting Standards Board.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Group s internal control over financial reporting as of 31 December 2018, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework), and our report dated 14 February 2019 expressed an unqualified opinion thereon.

Adoption of International Financial Reporting Standard 9 Financial Instruments

As discussed in section 1. Presentation of accounts of the Accounting policies to the financial statements, the Group changed its method of accounting for the classification, measurement and impairment of financial instruments in 2018 due to the adoption of IFRS 9 *Financial Instruments.*

Basis for Opinion

These financial statements are the responsibility of the Group s management. Our responsibility is to express an opinion on the Group s financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Group in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Ernst & Young LLP

We have served as the Group s auditors since 2016.

London, United Kingdom

14 February 2019 (except for the retrospective revisions to the reportable segments as discussed in Note 4 and changes in reporting standard as discussed in Note 7, as to which the date is 30 April 2019)

Consolidated income statement for the year ended 31 December 2018

	Note	2018 £m	2017 £m	2016 £m
Interest receivable		11,049	11,034	11,258
Interest payable		(2,393)	(2,047)	(2,550)
Net interest income	1	8,656	8,987	8,708
Fees and commissions receivable		3,218	3,338	3,340
Fees and commissions payable		(861)	(883)	(805)
Income from trading activities		1,507	634	974
Loss on redemption of own debt			(7)	(126)
Other operating income		882	1,064	499
Non-interest income	2	4,746	4,146	3,882
Total income		13,402	13,133	12,590
Staff costs		(4,122)	(4,676)	(5,124)
Premises and equipment		(1,383)	(1,565)	(1,388)
Other administrative expenses		(3,372)	(3,323)	(8,745)
Depreciation and amortisation		(731)	(808)	(778)
Write down of goodwill and other intangible assets		(37)	(29)	(159)
Operating expenses	3	(9,645)	(10,401)	(16,194)
Profit/(loss) before impairment losses		3,757	2,732	(3,604)
Impairment losses	14	(398)	(493)	(478)
Operating profit/(loss) before tax		3,359	2,239	(4,082)
Tax charge	7	(1,208)	(731)	(1,107)
Profit/(loss) for the year		2,151	1,508	(5,189)
Attributable to:				
Ordinary shareholders		1,622	752	(6,955)
Preference shareholders		182	234	260
Dividend access share				1,193
Paid-in equity holders		355	487	303
Non-controlling interests		(8)	35	10
		2,151	1,508	(5,189)
Earnings/(loss) per ordinary share	8	13.5p	6.3p	(59.5p)
Earnings/(loss) per ordinary share - fully diluted	8	13.4p	6.3p	(59.5p)

The accompanying notes on pages 191 to 249, the accounting policies on pages 186 to 190 and the audited sections of the Business review: Capital and risk management on pages 101 to 176 form an integral part of these financial statements.

Consolidated statement of comprehensive income for the year ended 31 December 2018

	Note	2018 £m	2017 £m	2016 £m
Profit/(loss) for the year		2,151	1,508	(5,189)
Items that do not qualify for reclassification				
Remeasurement of retirement benefit schemes	5			
- contributions in preparation for ring-fencing (1)		(2,053)		
- other movements		86	90	(1,049)
Profit/(loss) on fair value of credit in financial liabilities designated at fair value through profit or loss due to own credit risk		200	(126)	
Fair value through other comprehensive income (FVOCI) financial assets (2)		48		
Tax		502	(10)	288
		(1,217)	(46)	(761)
Items that do qualify for reclassification				
Fair value through other comprehensive income (FVOCI) financial assets (2)		7	26	(94)
Cash flow hedges		(581)	(1,069)	765
Currency translation		310	100	1,263
Tax		189	256	(106)
		(75)	(687)	1,828
Other comprehensive (loss)/income after tax		(1,292)	(733)	1,067
Total comprehensive income/(loss) for the year		859	775	(4,122)
Attributable to:				
Ordinary shareholders		305	2	(5,999)
Preference shareholders		182	234	260
Dividend access share				1,193
Paid-in equity holders		355	487	303
Non-controlling interests		17	52	121
		859	775	(4,122)

Notes:

(1) On 17 April 2018 RBS agreed a Memorandum of Understanding (MoU) with the Trustees of the RBS Group Pension Fund in connection with the requirements of ring-fencing. NatWest Markets Plc cannot continue to be a participant in the Main section and separate arrangements are required for its employees. Under the MoU NatWest Bank made a contribution of £2 billion on 9 October 2018 to strengthen funding of the Main section in recognition of the changes in covenant. Also under the MoU, NatWest Markets Plc is required to make a £53 million contribution to the NWM section in Q1 2019.

(2) Refer to Note 33 for further information on the impact of IFRS 9 on classification and basis of preparation, year ended 31 December 2018 prepared under IFRS 9 and prior years under IAS 39.

The accompanying notes on pages 191 to 249, the accounting policies on pages 186 to 190 and the audited sections of the Business review: Capital and risk management on pages 101 to 176 form an integral part of these financial statements.

Consolidated balance sheet as at 31 December 2018

	Note	2018 £m	2017 £m
Assets			
Cash and balances at central banks	11	88,897	98,337
Trading assets	9	75,119	85,991
Derivatives	10	133,349	160,843
Settlement balances		2,928	2,517
Loans to banks - amortised cost	11	12,947	11,517
Loans to customers - amortised cost	11	305,089	310,116
Securities subject to repurchase agreements		9,890	13,717
Other financial assets excluding securities subject to repurchase agreements		49,595	38,212
Other financial assets	15	59,485	51,929
Intangible assets	16	6,616	6,543
Other assets	17	9,805	10,263
Total assets		694,235	738,056
Liabilities			
Bank deposits	11	23,297	30,396
Customer deposits	11	360,914	361,316
Settlement balances		3,066	2,844
Trading liabilities	9	72,350	81,982
Derivatives	10	128,897	154,506
Other financial liabilities	18	39,732	30,326
Subordinated liabilities	19	10,535	12,722
Other liabilities	20	8,954	14,871
Total liabilities		647,745	688,963
Ordinary shareholders interests		41,182	41,707
Other owners interests		4,554	6,623
Owners equity	22	45,736	48,330
Non-controlling interests	21	754	763
Total equity		46,490	49,093
Total liabilities and equity		694,235	738,056

The accompanying notes on pages 191 to 249, the accounting policies on pages 186 to 190 and the audited sections of the Business review: Capital and risk management on pages 101 to 176 form an integral part of these financial statements.

The accounts were approved by the Board of directors on 14 February 2019 and signed on its behalf by:

Howard Davies Chairman	Ross McEwan Chief Executive	Katie Murray Chief Financial Officer

The Royal Bank of Scotland Group plc
Registered No. SC45551

Consolidated statement of changes in equity for the year ended 31 December 2018

	2018	2017	2016
	£m	£m	£m
Called-up share capital - at 1 January	11,965	11,823	11,625
Ordinary shares issued	84	142	198
At 31 December	12,049	11,965	11,823
Paid-in equity - at 1 January	4,058	4,582	2,646
Redeemed/reclassified (1)		(524)	(110)
Securities issued during the year (2)			2,046
At 31 December	4,058	4,058	4,582
Share premium account - at 1 January	887	25,693	25,425
Ordinary shares issued	140	235	268
Redemption of debt preference shares (3)		748	
Capital reduction (4)		(25,789)	
At 31 December	1,027	887	25,693
Merger reserve - at 1 January and 31 December	10,881	10,881	10,881
FVOCI reserve at 1 January (5)	255	238	307
Implementation of IFRS 9 on 1 January 2018	34		
Unrealised gains	97	202	282
Realised gains	(42)	(176)	(376)
Tax	(1)	(9)	25
At 31 December	343	255	238
Cash flow hedging reserve - at 1 January	227	1,030	458
Amount recognised in equity (6)	(63)	(277)	1,867
Amount transferred from equity to earnings (7)	(518)	(792)	(1,102)
Tax	163	266	(193)
At 31 December (8)	(191)	227	1,030
Foreign exchange reserve - at 1 January	2,970	2,888	1,674
Retranslation of net assets	195	111	1,470
Foreign currency losses on hedges of net assets	(33)	(6)	(278)
Tax	23	(1)	62
Recycled to profit or loss on disposal of businesses (9)	123	(22)	(40)
At 31 December (8)	3,278	2,970	2,888
Capital redemption reserve - at 1 January		4,542	4,542
Capital reduction (4)		(4,542)	
At 31 December			4,542
Retained earnings - at 1 January	17,130	(12,936)	(4,020)
Implementation of IFRS 9 on 1 January 2018 (5)	(105)		
Profit/(loss) attributable to ordinary shareholders and other equity owners	2,159	1,473	(5,199)
Equity preference dividends paid	(182)	(234)	(260)
Paid-in equity dividends paid	(355)	(487)	(303)
Ordinary dividends paid	(241)		
Capital reduction (4)		30,331	
Dividend access share dividend			(1,193)
Redemption of debt preference shares (3)		(748)	

Redemption of equity preference shares (10)	(2,805)		(1,160)
Redemption/reclassification of paid-in equity		(196)	(21)
Realised gains in period on FVOCI equity shares, net of tax	6		
Remeasurement of the retirement benefit schemes			
- contributions in preparation for ring-fencing (11)	(2,053)		
- other movements	86	90	(1,049)
- tax	539	(28)	288
Changes in fair value of credit in financial liabilities designated at fair value through profit or loss			
- gross	200	(126)	
- tax	(33)	18	
Shares issued under employee share schemes	(2)	(5)	(10)
Share-based payments	(32)	(22)	(9)
At 31 December	14,312	17,130	(12,936)
Own shares held - at 1 January	(43)	(132)	(107)
Shares issued under employee share schemes	87	161	41
Own shares acquired	(65)	(72)	(66)
At 31 December	(21)	(43)	(132)
Owners equity at 31 December	45,736	48,330	48,609

Consolidated statement of changes in equity for the year ended 31 December 2018

	2018	2017	2016
	£m	£m	£m
Non-controlling interests (see Note 21) - at 1 January	763	795	716
Currency translation adjustments and other movements	25	17	111
(Loss)/profit attributable to non-controlling interests	(8)	35	10
Dividends paid	(5)	(25)	
Equity withdrawn and disposals	(21)	(59)	(42)
At 31 December	754	763	795
Total equity at 31 December	46,490	49,093	49,404
Total equity is attributable to:			
Ordinary shareholders	41,182	41,707	41,462
Preference shareholders	496	2,565	2,565
Paid-in equity holders	4,058	4,058	4,582
Non-controlling interests	754	763	795
	46,490	49,093	49,404

Notes:

(1) Paid-in equity reclassified to liabilities as a result of the call of US$564 million and CAD321 million EMTN notes in August 2017 (redeemed in October 2017), the call of RBS Capital Trust D in March 2017 (redeemed in June 2017), the call of RBS Capital Trust C in May 2016 (redeemed in July 2016).
(2) AT1 capital notes totalling £2.0 billion issued in August 2016.
(3) During 2017, non-cumulative US dollar preference shares were redeemed at their original issue price of US$1.1 billion. The nominal value of £0.3 million was credited to the capital redemption reserve; share premium increased by £0.7 billion in respect of the premium received on issue, with a corresponding decrease in retained earnings. During 2016, non-cumulative US dollar preference shares were redeemed at their original issue price of US$1.5 billion. The nominal value of £0.3 million was transferred from share capital to capital redemption reserve and ordinary owners equity was reduced by £0.4 billion in respect of the movement in exchange rates since issue.
(4) On 15 June 2017, the Court of Session approved a reduction of RBSG plc capital so that the amounts which stood to the credit of share premium, account and capital redemption reserve were transferred to retained earnings.
(5) Refer to Note 33 for further information on the impact of IFRS 9 on classification and basis of preparation, year ended 31 December 2018 prepared under IFRS 9 prior years under IAS 39.
(6) The amount debited direct to the cash flow hedging reserve comprised £166 million in relation to interest rate hedges less a credit of £103 million in relation to foreign exchange hedges.
(7) The cash flow hedging reserve was reduced by £25 million in relation to foreign exchange hedges and £493 million in relation to interest rate hedges which were credited in aggregate to net interest income.
(8) The hedging element of the cash flow hedging reserve and foreign exchange reserve relate mainly to de-designated hedges.
(9) No tax impact.
(10) During 2018, non-cumulative US dollar, Euro and Sterling preference shares were redeemed.
(11) On 17 April 2018 RBS agreed a Memorandum of Understanding (MoU) with the Trustees of the RBS Group Pension Fund in connection with the requirements of ring-fencing. NatWest Markets Plc cannot continue to be a participant in the Main section and separate arrangements are required for its employees. Under the MoU NatWest Bank made a contribution of £2 billion on 9 October 2018 to strengthen funding of the Main section in recognition of the changes in covenant Also under the MoU, NatWest Markets Plc is required to make a £53 million contribution to the NWM section in Q1 2019.

The accompanying notes on pages 191 to 249, the accounting policies on pages 186 to 190 and the audited sections of the Business review: Capital and risk management on pages 101 to 176 form an integral part of these financial statements.

Consolidated cash flow statement for the year ended 31 December 2018

	Note	2018 £m	2017 £m	2016 £m
Cash flows from operating activities				
Operating profit/(loss) before tax		3,359	2,239	(4,082)
Interest on subordinated liabilities		461	572	845
Impairment releases on loans to banks and customers		(1,197)	(647)	(3,221)
Profit on sale of subsidiaries and associates			(155)	(22)
Profit on sale of securities		(34)	(226)	(71)
Defined benefit pension schemes		(2,055)	(252)	(4,518)
Provisions: expenditure in excess of charges		(5,016)	(4,546)	4,517
Depreciation, amortisation and impairment of property, plant, equipment, goodwill and intangibles		718	762	919
Loss on redemption of own debt			7	126
Elimination of foreign exchange differences		(160)	(426)	(6,518)
Other non-cash items		767	(214)	133
Net cash outflow from trading activities		(3,157)	(2,886)	(11,892)
Decrease/(increase) in net loans to banks and customers		2,627	2,466	(12,960)
(Increase)/decrease in securities		(47)	(1,319)	16,741
Decrease/(increase) in other assets		258	(221)	1,195
Increase in trading assets and liabilities		(2,087)		
Decrease/(increase) in derivative assets and liabilities		1,885	4,169	(2,696)
(Decrease)/increase in settlement balance assets and liabilities and short positions		(189)	8,658	104
(Decrease)/increase in banks and customers deposits		(8,164)	25,449	10,418
Increase/(decrease) in debt securities in issue		10,068	3,326	(3,967)
Decrease in other liabilities		(956)	(381)	(422)
Changes in operating assets and liabilities		3,395	42,147	8,413
Income taxes paid		(466)	(520)	(171)
Net cash flows from operating activities (1)		(228)	38,741	(3,650)
Cash flows from investing activities				
Sale and maturity of securities		9,062	11,656	8,599
Purchase of securities		(16,181)	(17,212)	(11,607)
Sale of property, plant and equipment		264	405	447
Purchase of property, plant and equipment		(619)	(1,132)	(912)
Net investment in business interests and intangible assets	28	(481)	(199)	(886)
Net cash flows from investing activities		(7,955)	(6,482)	(4,359)
Cash flows from financing activities				
Issue of ordinary shares		144	306	300
Issue of other equity instruments: Additional Tier 1 capital notes				2,046
Redemption of other equity instruments		(2,826)	(779)	(1,312)
Redemption of debt preference shares			(748)	
Own shares disposed/(acquired)		22	89	(25)
Redemption of subordinated liabilities		(2,258)	(5,747)	(3,606)
Service cost of other equity instruments		(803)	(612)	(1,697)
Interest on subordinated liabilities		(566)	(717)	(813)
Net cash flows from financing activities		(6,287)	(8,208)	(5,107)
Effects of exchange rate changes on cash and cash equivalents		676	(16)	8,094
Net (decrease)/increase in cash and cash equivalents		(13,794)	24,035	(5,022)
Cash and cash equivalents at 1 January		122,605	98,570	103,592
Cash and cash equivalents at 31 December	30	108,811	122,605	98,570

Note:

(1) Includes interest received of £10,927 million (2017 - £10,946 million, 2016 - £11,321 million) and interest paid of £2,511 million (2017 - £2,300 million, 2016 - £2,638 million).

The accompanying notes on pages 191 to 249, the accounting policies on pages 186 to 190 and the audited sections of the Business review: Capital and risk management on pages 101 to 176 form an integral part of these financial statements.

Accounting policies

1. Presentation of accounts

The accounts, set out on pages 180 to 249 including these accounting policies on pages 186 to 190 and the audited sections of the Financial review: Capital and risk management on pages 101 to 176, are prepared on a going concern basis (see the Report of the directors, page 98) and in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IASB) and interpretations as issued by the IFRS Interpretations Committee of the IASB and adopted by the European Union (EU) (together IFRS).).

The company is incorporated in the UK and registered in Scotland. Its accounts are presented in accordance with the Companies Act 2006.

With the exception of investment property and certain financial instruments as described in Accounting policies 8, 13, and 21, the accounts are presented on an historical cost basis.

Adoption of IFRS 9

Refer to Note 33 for details of the adoption of IFRS 9.

Other amendments to IFRS

IFRS 15 Revenue from Contracts with Customers has been adopted with effect from 1 January 2018. The Accounting policy is updated to reflect the terminology in the new standard but it has had no effect on financial information reported in the current or comparative periods. Interest income and expense continues to be recognised using the effective interest rate method for financial instruments measured at historical cost. There has been no restatement of profit or loss for comparative periods.

Other amendments to IFRS effective for 2018, including IFRS 2 Share-based payments and IAS 40 Investment Property have not had a material effect on the Group s financial statements.

2. Basis of consolidation

The consolidated accounts incorporate the financial statements of the company and entities (including certain structured entities) that are controlled by the Group. The Group controls another entity (a subsidiary) when it is exposed, or has rights, to variable returns from its involvement with that entity and has the ability to affect those returns through its power over the other entity; power generally arises from 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. A subsidiary is included in the consolidated financial statements from the date it is controlled by the Group until the date the Group ceases to control it through a sale or a significant change in circumstances.

Changes in the Group s interest in a subsidiary that do not result in the Group ceasing to control that subsidiary are accounted for as equity transactions. All intergroup balances, transactions, income and expenses are eliminated on consolidation. The consolidated accounts are prepared under uniform accounting policies.

3. Revenue recognition

Interest income or expense on financial instruments that are measured at amortised cost and fair value through comprehensive income is determined using the effective interest rate method. The effective interest rate allocates the interest income or interest expense over the expected life of the asset or liability at the rate that exactly discounts all estimated future cash flows to equal the instrument s initial carrying amount. Calculation of the effective interest rate takes into account fees payable or 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. Negative effective interest accruing to financial assets is presented in interest payable.

Net interest income in the income statement only relates to financial instruments measured at amortised cost; the interest on debt instruments classified as fair value through OCI; and the effective part of any related accounting hedging instruments. Other interest relating to financial instruments measured at fair value is recognised as part of the movement in fair value.

Fees in respect of services are recognised as the right to consideration accrues through the performance of each distinct service obligation to the customer. The arrangements are generally contractual and the cost of providing the service is incurred as each service is performed. The price is usually fixed and always determinable.

4. Assets held for sale and discontinued operations

A non-current asset (or disposal group) is classified as held for sale if the Group will recover its carrying amount principally through a sale transaction rather than through continuing use. A non-current asset (or disposal group) classified as held for sale is measured at the lower of its carrying amount and fair value less costs to sell.

5. Employee benefits

Short-term employee benefits, such as salaries, paid absences, and other benefits are accounted for on an accruals basis over the period in which the employees provide the related services. Employees may receive variable compensation satisfied by cash, by debt instruments issued by the Group or by RBSG shares. The treatment of share-based compensation is set out in Accounting policy 23. Variable compensation that is settled in cash or debt instruments is charged to profit or loss over the period from the start of the year to which the variable compensation relates to the expected settlement date taking account of forfeiture and clawback criteria.

Contributions to defined contribution pension schemes are recognised in profit or loss when payable.

For defined benefit schemes, the defined benefit obligation is measured on an actuarial basis using the projected unit credit method and discounted at a rate determined by reference to market yields at the end of the reporting period on high quality corporate bonds of equivalent term and currency to the scheme liabilities. Scheme assets are measured at their fair value. The difference between scheme assets and scheme liabilities, the net defined benefit asset or liability, is recognised in the balance sheet. A defined benefit asset is limited to the present value of any economic benefits available to the Group in the form of refunds from the plan or reduced contributions to it.

The charge to profit or loss for pension costs (recorded in operating expenses) comprises:

- the current service cost
- interest, computed at the rate used to discount scheme liabilities, on the net defined benefit liability or asset
- past service cost resulting from a scheme amendment or curtailment
- gains or losses on settlement.

A curtailment occurs when the Group significantly reduces the number of employees covered by a plan. A plan amendment occurs when the Group introduces, or withdraws, a defined benefit plan or changes the benefits payable under an existing defined benefit plan. Past service cost may be either positive (when benefits are introduced or changed so that the present value of the defined benefit obligation increases) or negative (when benefits are withdrawn or changed so that the present value of the defined benefit obligation decreases). A settlement is a transaction that eliminates all further obligation for part or all of the benefits.

Actuarial gains and losses (i.e. gains or and losses on re-measuring the net defined benefit asset or liability) are recognised in other comprehensive income in full in the period in which they arise.

6. Intangible assets and goodwill

Intangible assets acquired by the Group are stated at cost less accumulated amortisation and impairment losses. Amortisation is charged to profit or loss over the assets estimated economic lives using methods that best reflect the pattern of economic benefits and is included in Depreciation and amortisation. These estimated useful economic lives are:

Computer software	3 to 12 years
Other acquired intangibles	5 to 10 years

Expenditure on internally generated goodwill and brands is written-off as incurred. Direct costs relating to the development of internal-use computer software are capitalised once technical feasibility and economic viability have been established. These costs include payroll, the costs of materials and services, and directly attributable overheads. Capitalisation of costs ceases when the software is capable of operating as intended. During and after development, accumulated costs are reviewed for impairment against the benefits that the software is expected to generate. Costs incurred prior to the establishment of technical feasibility and

Accounting policies

economic viability are expensed as incurred as are all training costs and general overheads. The costs of licences to use computer software that are expected to generate economic benefits beyond one year are also capitalised.

Intangible assets include goodwill arising on the acquisition of subsidiaries and joint ventures. Goodwill on the acquisition of a subsidiary is the excess of the fair value of the consideration transferred, the fair value of any existing interest in the subsidiary and the amount of any non-controlling interest measured either at fair value or at its share of the subsidiary s net assets over net fair value of the subsidiary s identifiable assets, liabilities and contingent liabilities.

Goodwill arises on the acquisition of a joint venture when the cost of investment exceeds the Group s share of the net fair value of the joint venture s identifiable assets and liabilities. Goodwill is measured at initial cost less any subsequent impairment losses. Goodwill arising on the acquisition of associates is included within their carrying amounts. The gain or loss on the disposal of a subsidiary, associate or joint venture includes the carrying value of any related goodwill.

7. Impairment of intangible assets and property, plant and equipment

At each balance sheet date, the Group assesses whether there is any indication that its intangible assets, or property, plant and equipment are impaired. If any such indication exists, the Group estimates the recoverable amount of the asset and the impairment loss if any. Goodwill is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired.

If an asset does not generate cash flows that are independent from those of other assets or groups of assets, the recoverable amount is determined for the cash-generating unit to which the asset belongs. A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. For the purposes of impairment testing, goodwill acquired in a business combination is allocated to each of the Group s cash-generating units or groups of cash-generating units expected to benefit from the combination. The recoverable amount of an asset or cash-generating unit is the higher of its fair value less cost to sell and its value in use. Value in use is the present value of future cash flows from the asset or cash-generating unit discounted at a rate that reflects market interest rates adjusted for risks specific to the asset or cash-generating unit that have not been taken into account in estimating future cash flows. If the recoverable amount of an intangible or tangible asset is less than its carrying value, an impairment loss is recognised immediately in profit or loss and the carrying value of the asset reduced by the amount of the loss. A reversal of an impairment loss on intangible assets (excluding goodwill) or property, plant and equipment can be recognised when an increase in service potential arises provided the increased carrying value is not greater than it would have been had no impairment loss been recognised. Impairment losses on goodwill are not reversed.

8. Investment property

Investment property comprises freehold and leasehold properties that are held to earn rentals or for capital appreciation or both. Investment property is not depreciated but is stated at fair value. Fair value is based on current prices for similar properties in the same location and condition. Any gain or loss arising from a change in fair value is recognised in profit or loss. Rental income from investment property is recognised on a straight-line basis over the term of the lease in Other operating income. Lease incentives granted are recognised as an integral part of the total rental income.

9. Foreign currencies

The Group s consolidated financial statements are presented in sterling which is the functional currency of the company.

Transactions in foreign currencies are recorded in the functional currency at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the relevant functional currency at the foreign exchange rates ruling at the balance sheet date. Foreign exchange differences arising on the settlement of foreign currency transactions and from the translation of monetary assets and liabilities are reported in income from trading activities except for differences arising on cash flow hedges and hedges of net investments in foreign operations (see Accounting policy 21).

Non-monetary items denominated in foreign currencies that are stated at fair value are translated into the relevant functional currency at the foreign exchange rates ruling at the dates the values are determined. Translation differences arising on non-monetary items measured at fair value are recognised in profit or loss except for differences arising on non-monetary financial assets classified as available for sale, for example equity shares, which are recognised in other comprehensive income unless the asset is the hedged item in a fair value hedge.

Assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into sterling at foreign exchange rates ruling at the balance sheet date. Income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions. Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income. The amount accumulated in equity is reclassified from equity to profit or loss on disposal of a foreign operation.

10. Leases

As lessor

Contracts with customers to lease assets are classified as finance leases if they transfer substantially all the risks and rewards of ownership of the asset to the customer; all other contracts with customers to lease assets are classified as operating leases.

Finance lease receivables are included in the balance sheet, within net loans to customers, at the amount of the net investment in the lease being the minimum lease payments and any unguaranteed residual value discounted at the interest rate implicit in the lease. Finance lease income is allocated to accounting periods so as to give a constant periodic rate of return before tax on the net investment and included in Interest receivable. Unguaranteed residual values are subject to regular review; if there is a reduction in their value, income allocation is revised and any reduction in respect of amounts accrued is recognised immediately.

Rental income from operating leases is recognised in income on a straight-line basis over the lease term unless another systematic basis better represents the time pattern of the asset s use. Operating lease assets are included within Property, plant and equipment and depreciated over their useful lives. Operating lease rentals receivable are included in Other operating income.

As lessee

The Group s contracts to lease assets are principally operating leases. Operating lease rental expense is included in Premises and equipment costs and recognised as an expense on a straight-line basis over the lease term unless another systematic basis better represents the benefit to the Group.

11. Provisions

The Group recognises a provision for a present obligation resulting from a past event when it is more likely than not that it will be required to transfer economic benefits to settle the obligation and the amount of the obligation can be estimated reliably.

Provision is made for restructuring costs, including the costs of redundancy, when the Group has a constructive obligation to restructure. An obligation exists when the Group has a detailed formal plan for the restructuring and has raised a valid expectation in those affected by starting to implement the plan or by announcing its main features.

If the Group has a contract that is onerous, it recognises the present obligation under the contract as a provision. An onerous contract is one where the unavoidable costs of meeting the Group s contractual obligations exceed the expected economic benefits. When the Group vacates a leasehold property, a provision is recognised for the costs under the lease less any expected economic benefits (such as rental income).

Contingent liabilities are possible obligations arising from past events, whose existence will be confirmed only by uncertain future events, or present obligations arising from past events that are not recognised because either an outflow of economic benefits is not probable or the amount of the obligation cannot be reliably measured. Contingent liabilities are not recognised but information about them is disclosed unless the possibility of any outflow of economic benefits in settlement is remote.

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12. Tax

Income tax expense or income, comprising current tax and deferred tax, is recorded in the income statement except income tax on items recognised outside profit or loss which is credited or charged to other comprehensive income or to equity as appropriate.

Current tax is income tax payable or recoverable in respect of the taxable profit or loss for the year arising in profit or loss, other comprehensive income or equity. Provision is made for current tax at rates enacted or substantively enacted at the balance sheet date.

Deferred tax is the tax expected to be payable or recoverable in respect of temporary differences between the carrying amount of an asset or liability for accounting purposes and its carrying amount for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that the asset will be recovered.

Deferred tax is not recognised on temporary differences that arise from initial recognition of an asset or a liability in a transaction (other than a business combination) that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax is calculated using tax rates expected to apply in the periods when the assets will be realised or the liabilities settled, based on tax rates and laws enacted, or substantively enacted, at the balance sheet date.

Deferred tax assets and liabilities are offset where the Group has a legally enforceable right to offset and where they relate to income taxes levied by the same taxation authority either on an individual Group company or on Group companies in the same tax group that intend, in future periods, to settle current tax liabilities and assets on a net basis or on a gross basis simultaneously.

13. Financial instruments

On initial recognition, financial instruments are measured at fair value. Subsequently they are classified as follows: designated at fair value through profit or loss; amortised cost, the default class for liabilities; fair value through profit or loss, the default class for assets; or financial assets may be designated as at fair value through other comprehensive income. Regular way purchases of financial assets classified as amortised cost are recognised on the settlement date; all other regular way transactions in financial assets are recognised on the trade date.

Designated as at fair value through profit or loss a financial instrument may be designated as at fair value through profit or loss only if such designation (a) eliminates or significantly reduces a measurement or recognition inconsistency; or (b) applies to a group of financial assets, financial liabilities or both, that the Group manages and evaluates on a fair value basis; or (c) relates to a financial liability that contains an embedded derivative which is not evidently closely related to the host contract. Financial assets that the Group designates on initial recognition as being at fair value through profit or loss are recognised at fair value, with transaction costs being recognised in profit or loss, and are subsequently measured at fair value. Gains and losses are recognised in profit or loss as they arise.

Amortised cost assets have to meet both the following criteria:

(a) the asset is held within a business model whose objective is solely to hold assets to collect contractual cash flows; and

(b) the contractual terms of the financial asset are solely payments of principal and interest on the outstanding balance.

Amortised cost liabilities all liabilities that are not subsequently measured at fair value are measured at amortised cost.

Assets designated at fair value through other comprehensive income An equity instrument may be designated irrevocably at fair value through other comprehensive income. Other assets have to meet both the following criteria:

(a) the asset is held within a business model whose objective is both to hold assets to collect contractual cash flows and selling financial assets; and

(b) the contractual terms of the financial asset are solely payments of principal and interest on the outstanding balance.

Fair value through profit or loss - a financial liability is measured at fair value if it arises from: a financial guarantee contract; a commitment to lend at below market rates; an obligation arising from the failed sale of an asset; or a contingent consideration for a business acquisition. Fair value through profit or loss is the default classification for a financial asset.

Reclassifications financial liabilities cannot be reclassified. Financial assets are only reclassified where there has been a change in the business model.

Fair value the fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Business model assessment business models are assessed at portfolio level, being the level at which they are managed. This is expected to result in the most consistent classification of assets because it aligns with the stated objectives of the portfolio, its risk management, manager s remuneration and the ability to monitor sales of assets from a portfolio. The criteria for classifying cash flows as solely principal and interest are assessed against the contractual terms of a facility, with attention to leverage features; prepayment and extension terms; and triggers that might reset the effective rate of interest.

14. Impairments

At each balance sheet date each financial asset or portfolio of loans measured at amortised cost or at fair value through other comprehensive income, issued financial guarantee and loan commitment is assessed for impairment. Loss allowances are forward-looking, based on 12 month expected credit losses where there has not been a significant increase in credit risk rating, otherwise allowances are based on lifetime expected losses. Loss allowances for lease receivables are always made on a lifetime basis.

Expected credit losses are a probability-weighted estimate of credit losses. The probability is determined by the risk of default which is applied to the cash flow estimates. In the absence of a change in credit rating, allowances are recognised when there is reduction in the net present value of expected cash flows. On a significant increase in credit risk, allowances are recognised without a change in the expected cash flows, although typically expected cash flows do also change; and expected credit losses are rebased from 12 month to lifetime expectations.

On restructuring a financial asset without causing derecognition of the original asset the revised cash flows are used in re-estimating the credit loss. Where restructuring causes derecognition of the original financial asset, the fair value of the replacement asset is used as the closing cash flow of the original asset.

Where, in the course of the orderly realisation of a loan, it is exchanged for equity shares or property, the exchange is accounted for as the sale of the loan and the acquisition of equity securities or investment property. Where the Group s interest in equity shares following the exchange is such that the Group controls an entity, that entity is consolidated.

The costs of loss allowances on assets held at amortised cost are presented as impairments in the income statement. Allowances in respect financial guarantees and loan commitments are presented in administrative expenses.

Impaired loans and receivables are written off, when the Group concludes that there is no longer any realistic prospect of recovery of part or all of the loan. For loans that are individually assessed for impairment, the timing of write off is determined on a case-by-case basis. Such loans are reviewed regularly and write off will be prompted by bankruptcy, insolvency, renegotiation and similar events.

The typical time frames from initial impairment to write off for the Group s collectively-assessed portfolios are:

- Retail mortgages: write off usually occurs within five years, or when an account is closed if earlier.
- Credit cards: the irrecoverable amount is written off after 12 months; three years later any remaining amounts outstanding are written off. Overdrafts and other unsecured loans: write off occurs within six years.
- Overdrafts and other unsecured loans: write off occurs within six years
- Commercial loans: write offs are determined in the light of individual circumstances; the period does not exceed five years.
- Business loans are generally written off within five years.

15. Financial guarantee contracts

Under a financial guarantee contract, the Group, in return for a fee, undertakes to meet a customer s obligations under the terms of a debt instrument if the customer fails to do so.

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A financial guarantee is recognised as a liability; initially at fair value and, if not designated as at fair value through profit or loss, subsequently at the higher of its initial value less cumulative amortisation and any provision under the contract measured in accordance with Accounting policy 13. Amortisation is calculated so as to recognise fees receivable in profit or loss over the period of the guarantee.

16. Loan commitments

Provision is made for expected credit loss on loan commitments, other than those classified as held-for-trading. Syndicated loan commitments in excess of the level of lending under the commitment approved for retention by the Group are classified as held-for-trading and measured at fair value.

17. Derecognition

A financial asset is derecognised when the contractual right to receive cash flows from the asset has expired or when it has been transferred and the transfer qualifies for derecognition. A transfer requires that the Group either (a) transfers the contractual rights to receive the asset s cash flows; or (b) retains the right to the asset s cash flows but assumes a contractual obligation to pay those cash flows to a third party. After a transfer, the Group assesses the extent to which it has retained the risks and rewards of ownership of the transferred asset. The asset remains on the balance sheet if substantially all the risks and rewards have been retained. It is derecognised if substantially all the risks and rewards have been transferred.

If substantially all the risks and rewards have been neither retained nor transferred, the Group assesses whether or not it has retained control of the asset. If the Group has retained control of the asset, it continues to recognise the asset to the extent of its continuing involvement; if the Group has not retained control of the asset, it is derecognised.

A financial liability is removed from the balance sheet when the obligation is discharged, or is cancelled, or expires. On the redemption or settlement of debt securities (including subordinated liabilities) issued by the Group, the Group derecognises the debt instrument and records a gain or loss being the difference between the debt s carrying amount and the cost of redemption or settlement. The same treatment applies where the debt is exchanged for a new debt issue that has terms substantially different from those of the existing debt. The assessment of whether the terms of the new debt instrument are substantially different takes into account qualitative and quantitative characteristics including a comparison of the present value of the cash flows under the new terms with the present value of the remaining cash flows of the original debt issue discounted at the effective interest rate of the original debt issue.

18. Sale and repurchase transactions

Securities subject to a sale and repurchase agreement under which substantially all the risks and rewards of ownership are retained by the Group continue to be shown on the balance sheet and the sale proceeds recorded as a financial liability. Securities acquired in a reverse sale and repurchase transaction under which the Group is not exposed to substantially all the risks and rewards of ownership are not recognised on the balance sheet and the consideration paid is recorded as a financial asset.

Securities borrowing and lending transactions are usually secured by cash or securities advanced by the borrower. Borrowed securities are not recognised on the balance sheet or lent securities derecognised. Cash collateral given or received is treated as a loan or deposit; collateral in the form of securities is not recognised. However, where securities borrowed are transferred to third parties, a liability for the obligation to return the securities to the stock lending counterparty is recorded.

19. Netting

Financial assets and financial liabilities are offset and the net amount presented in the balance sheet when, and only when, the Group currently has a legally enforceable right to set off the recognised amounts and it intends either to settle on a net basis or to realise the asset and settle the liability simultaneously. The Group is party to a number of arrangements, including master netting agreements, that give it the right to offset financial assets and financial liabilities, but where it does not intend to settle the amounts net or simultaneously, the assets and liabilities concerned are presented gross.

20. Capital instruments

The Group classifies a financial instrument that it issues as a liability if it is a contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities on potentially unfavourable terms and as equity if it evidences a residual interest in the assets of the Group after the deduction of liabilities. The components of a compound financial instrument issued by the Group are classified and accounted for separately as financial assets, financial liabilities or equity as appropriate. Incremental costs and related tax that are directly attributable to an equity transaction are deducted from equity.

The consideration for any ordinary shares of the company purchased by the Group (treasury shares) is deducted from equity. On the cancellation of treasury shares their nominal value is removed from equity and any excess of consideration over nominal value is treated in accordance with the capital maintenance provisions of the Companies Act. On the sale or reissue of treasury shares the consideration received and related tax are credited to equity, net of any directly attributable incremental costs.

21. Derivatives and hedging

In accordance with IAS 39 hedge relationships , derivative financial instruments are initially recognised, and subsequently measured, at fair value.

A derivative embedded in a contract is accounted for as a stand-alone derivative if its economic characteristics are not closely related to the economic characteristics of the host contract; unless the host is a financial asset or the entire contract is measured at fair value with changes in fair value recognised in profit or loss.

Gains and losses arising from changes in the fair value of derivatives that are not the hedging instrument in a qualifying hedge are recognised as they arise in profit or loss. Gains and losses are recorded in Income from ordinary activities except for gains and losses on those derivatives that are managed together with financial instruments designated at fair value; these gains and losses are included in Other operating income. The Group enters into three types of hedge relationship: hedges of changes in the fair value of a recognised asset or liability or unrecognised firm commitment (fair value hedges); hedges of the variability in cash flows from a recognised asset or liability or a highly probable forecast transaction (cash flow hedges); and hedges of the net investment in a foreign operation.

Hedge relationships are formally designated and documented at inception. The documentation identifies the hedged item and the hedging instrument and details the risk that is being hedged and the way in which effectiveness will be assessed at inception and during the period of the hedge. If the hedge is not highly effective in offsetting changes in fair values or cash flows attributable to the hedged risk, consistent with the documented risk management strategy, hedge accounting is discontinued. Hedge accounting is also discontinued if the Group revokes the designation of a hedge relationship.

Fair value hedge - in a fair value hedge, the gain or loss on the hedging instrument is recognised in profit or loss. The gain or loss on the hedged item attributable to the hedged risk is recognised in profit or loss and, where the hedged item is measured at amortised cost, adjusts the carrying amount of the hedged item. Hedge accounting is discontinued if the hedge no longer meets the criteria for hedge accounting; or if the hedging instrument expires or is sold, terminated or exercised; or if hedge designation is revoked. If the hedged item is one for which the effective interest rate method is used, any cumulative adjustment is amortised to profit or loss over the life of the hedged item using a recalculated effective interest rate.

Cash flow hedge - in a cash flow hedge, the effective portion of the gain or loss on the hedging instrument is recognised in other comprehensive income and the ineffective portion in profit or loss. When the forecast transaction results in the recognition of a financial asset or financial liability, the cumulative gain or loss is reclassified from equity to profit or loss in the same periods in which the hedged forecast cash flows affect profit or loss. Otherwise the cumulative gain or loss is removed from equity and recognised in profit or loss at the same time as the hedged transaction. Hedge accounting is discontinued if the hedge no longer meets the criteria for hedge accounting; if the hedging instrument expires or is sold, terminated or exercised; if the forecast transaction is no

Accounting policies

longer expected to occur; or if hedge designation is revoked. On the discontinuance of hedge accounting (except where a forecast transaction is no longer expected to occur), the cumulative unrealised gain or loss is reclassified from equity to profit or loss when the hedged cash flows occur or, if the forecast transaction results in the recognition of a financial asset or financial liability, when the hedged forecast cash flows affect profit or loss. Where a forecast transaction is no longer expected to occur, the cumulative unrealised gain or loss is reclassified from equity to profit or loss immediately.

Hedge of net investment in a foreign operation - in the hedge of a net investment in a foreign operation, the portion of foreign exchange differences arising on the hedging instrument determined to be an effective hedge is recognised in other comprehensive income. Any ineffective portion is recognised in profit or loss. Non-derivative financial liabilities as well as derivatives may be the hedging instrument in a net investment hedge. On disposal or partial disposal of a foreign operation, the amount accumulated in equity is reclassified from equity to profit or loss.

22. Associates and joint ventures

An associate is an entity over which the Group has significant influence. A joint venture is one which it controls jointly with other parties.

Investments in associates and interests in joint ventures are recognised using the equity method. They are stated initially at cost, including attributable goodwill, and subsequently adjusted for post-acquisition changes in the Group s share of net assets.

23. Share-based compensation

The Group operates a number of share-based compensation schemes under which it awards RBSG shares and share options to its employees. Such awards are generally subject to vesting conditions: conditions that vary the amount of cash or shares to which an employee is entitled. Vesting conditions include service conditions (requiring the employee to complete a specified period of service) and performance conditions (requiring the employee to complete a specified period of service and specified performance targets to be met). Other conditions to which an award is subject are non-vesting conditions (such as a requirement to save throughout the vesting period).

The cost of employee services received in exchange for an award of shares or share options is measured by reference to the fair value of the shares or share options on the date the award is and takes into account non-vesting conditions and market performance conditions (conditions related to the market price of RBSG shares): an award is treated as vesting irrespective of whether any market performance condition or non-vesting condition is met. The fair value of options is estimated using valuation techniques which incorporate exercise price, term, risk-free interest rates, the current share price and its expected volatility. The cost is expensed on a straight-line basis over the vesting period (the period during which all the specified vesting conditions must be satisfied) with a corresponding increase in equity in an equity-settled award, or a corresponding liability in a cash-settled award. The cost is adjusted for vesting conditions (other than market performance conditions) so as to reflect the number of shares or share options that actually vest.

If an award is modified, the original cost continues to be recognised as if there had been no modification. Where modification increases the fair value of the award, this increase is recognised as an expense over the modified vesting period. A new award of shares or share options is treated as the modification of a cancelled award if, on the date the new award is, the Group identifies them as replacing the cancelled award. The cancellation of an award through failure to meet non-vesting conditions triggers an immediate expense for any unrecognised element of the cost of an award.

24. Cash and cash equivalents

In the cash flow statement, cash and cash equivalents comprises cash and deposits with banks with an original maturity of less than three months together with short-term highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risk of change in value.

Critical accounting policies and key sources of estimation uncertainty

The reported results of the Group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. UK company law and IFRS require the directors, in preparing the Group s financial statements, to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent. In the absence of an applicable standard or interpretation, IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors , requires management to develop and apply an accounting policy that results in relevant and reliable information in the light of the requirements and guidance in IFRS dealing with similar and related issues and the IASB s Conceptual Framework for Financial Reporting . The judgements and assumptions involved in the Group s accounting policies that are considered by the Board to be the most important to the portrayal of its financial condition are discussed below. The use of estimates, assumptions or models that differ from those adopted by the Group would affect its reported results

Critical accounting policy	Note
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Provisions for liabilities and charges	226

Accounting Developments

International Financial Reporting Standards

A number of IFRS s and amendments to IFRS were in issue at 31 December 2018 that would affect the Group from 1 January 2019 or later

Effective 1 January 2019

IFRS 16 Leases was issued in January 2016 to replace IAS 17 Leases . The Group will apply the standard with effect from 1 January 2019. Lessees will capitalise operating leases through the recognition of assets representing the contractual rights of use. The present value of contractual payments will be recognised as lease liabilities.

The Group has new models and processes to implement IFRS 16. The most significant impact from initially applying IFRS 16 will be to recognise rights of use assets in respect of branches and office properties leased by the Group under contracts classified as operating leases under IAS 17. The present value of other contracts is immaterial. The Group will apply IFRS 16 on a modified retrospective basis without restating prior years and electing for the following exemptions on transition at 1 January 2019. The Group will

- apply IFRS 16 to contracts previously identified as leases by IAS 17
- use the incremental borrowing rate as the discount rate
- not apply IFRS 16 to operating leases with a remaining lease term of less than 12 months or low value leases (non property leases)

- rely on the assessment of whether the lease contract is onerous under IAS 37 at 31 December 2018 as an alternative to performing an impairment review of the right of use assets created on 1 January 2019 Where this is the case the carrying amount of the assets will be adjusted by the onerous lease provision.

- exclude initial direct costs from the measurement of the right of use asset

The opening balance sheet at 1 January 2019 will be adjusted to create a right of use asset of approximately £1.3 billion. A lease liability will also be recognised of £1.9 billion. Retained earnings will decrease by £0.2 billion after tax. This will have an estimated impact of 21 basis points on the CET 1 ratio. Application of IFRS 16 by the Group is not expected to have a significant impact on lessor accounting or for finance lease accounting by lessees.

Effective after 2019

IFRS 17 Insurance contracts was issued in May 2017 to replace IFRS 4 and to establish a comprehensive standard for inceptors of insurance policies. The effective date is 1 January 2021, subject to IASB s approval of a deferral until 1 January 2022.

In February 2018 the IASB amended IAS 19 Employee Benefits to clarify the need to update assumptions whenever there is a plan amendment, curtailment or settlement.

The Group is assessing the effect of adopting these standards on its financial statements.

Notes on the consolidated accounts

1 Net interest income

	2018	2017	2016
	£m	£m	£m
Loans to banks - amortised cost	522	277	246
Loans to customers - amortised cost	9,993	10,409	10,706
Other financial assets	534	348	306
Interest receivable (1)	11,049	11,034	11,258
Balances with banks	250	175	97
Customer deposits: demand	223	99	433
Customer deposits: savings	510	445	432
Customer deposits: other time	116	179	190
Other financial liabilities	791	554	557
Subordinated liabilities	461	572	845
Internal funding of trading businesses	42	23	(4)
Interest payable (1)	2,393	2,047	2,550
Net interest income	8,656	8,987	8,708

Note:

(1) Negative interest on loans is classed as interest payable and on customer deposits is classed as interest receivable.

2 Non-interest income

	2018	2017	2016
	£m	£m	£m
Net fees and commissions	2,357	2,455	2,535
Loss on redemption of own debt		(7)	(126)
Income from trading activities			
Foreign exchange	643	525	989
Interest rate	695	(50)	(480)
Credit	45	197	336
Changes in fair value of own debt and derivative liabilities attributable to own credit			
- debt securities in issue	72	12	87
- derivative liabilities	20	(81)	67
Equities, commodities and other	32	31	(25)
	1,507	634	974
Other operating income			
Operating lease and other rental income	256	276	287
Changes in the fair value of financial assets and liabilities designated at fair value through profit or loss	(26)	60	(13)
Changes in the fair value of own debt designated as at fair value through profit or loss attributable to own credit risk			
- debt securities in issue			41
- subordinated liabilities			(15)
Changes in fair value of other financial assets fair value through profit or loss	18		
Hedge ineffectiveness	(65)	39	

Profit/(loss) on disposal of amortised cost assets	44	(35)	(277)
Profit on disposal of fair value through other comprehensive income assets	34	226	71
Profit on sale of property, plant and equipment	50	75	18
Share of profits of associated entities	83	104	59
(Loss)/profit on disposal of subsidiaries and associates	(72)	245	273
Other income (1)	560	74	55
	882	1,064	499
Non-interest income	4,746	4,146	3,882

Note:

(1) Includes income from activities other than banking. 2018 includes insurance recoveries of £357 million.

Notes on the consolidated accounts

3 Operating expenses

	2018	2017	2016
	£m	£m	£m
Salaries	3,002	3,180	3,771
Variable compensation	225	298	281
Social security costs	307	318	388
Pension costs	401	467	357
Other	187	413	327
Staff costs	4,122	4,676	5,124
Premises and equipment	1,383	1,565	1,388
UK bank levy	179	215	190
Depreciation and amortisation	731	808	778
Other administrative expenses (1)	3,193	3,108	8,555
Administrative expenses	5,486	5,696	10,911
Write down of goodwill and other intangible assets	37	29	159
	9,645	10,401	16,194

Note:

(1) Includes litigation and conduct costs, net of amounts recovered. Refer to Notes 20 and 27 for further details.

The average number of persons employed, rounded to the nearest hundred, during the year, excluding temporary staff, was 67,600 (2017 - 73,400; 2016 - 82,400). The average number of temporary employees during 2018 was 4,000 (2017 - 5,000; 2016 - 6,700). The number of persons employed at 31 December, excluding temporary staff, by reportable segment, was as follows:

	2018	2017	2016
UK Personal Banking	23,400	19,500	22,600
Ulster Bank RoI	2,900	2,600	3,000
Personal & Ulster	26,300	22,100	25,600
Commercial Banking	10,200	6,900	8,100
Private Banking	1,900	1,500	1,700
Commercial & Private Banking	12,100	8,400	9,800
RBS International	1,600	1,600	800
NatWest Markets	4,500	5,300	1,500
Central items & other	20,900	32,300	39,300
Total	65,400	69,700	77,000
UK	46,600	51,200	57,300
USA	500	500	700
Europe	4,100	4,200	5,200
Rest of the World	14,200	13,800	13,800
Total	65,400	69,700	77,000

During 2018 the reporting lines of central and support staff directly supporting a reportable Group segment were realigned to that segment.

Share-based payments

As described in the Remuneration report, the Group grants share-based awards to employees principally on the following bases:

Award plan	Eligible employees	Nature of award	Vesting conditions (1)	Settlement
Sharesave	UK, Republic of Ireland, Channel Islands, Gibraltar and Isle of Man	Option to buy shares under employee savings plan	Continuing employment or leavers in certain circumstances	2019 to 2023
Deferred performance awards	All	Awards of ordinary shares	Continuing employment or leavers in certain circumstances	2019 to 2025
Long-term incentives (2)	Senior employees	Awards of conditional shares or share options	Continuing employment or leavers in certain circumstances and/or achievement of performance conditions	2019 to 2025

Notes:

(1) All awards have vesting conditions and therefore some may not vest.

(2) Long-term incentives include the Executive Share Option Plan, the Long-Term Incentive Plan and the Employee Share Plan.

Notes on the consolidated accounts

3 Operating expenses continued

The fair value of options granted in 2018 was determined using a pricing model that included: expected volatility of shares determined at the grant date based on historical volatility over a period of up to five years; expected option lives that equal the vesting period; no dividends on equity shares; and risk-free interest rates determined from UK gilts with terms matching the expected lives of the options.

The strike price of options and the fair value on granting awards of fully paid shares is the average market price over the five trading days (three trading days for Sharesave) preceding grant date.

Sharesave	2018		2017		2016	
	Average exercise price £	Shares under option (million)	Average exercise price £	Shares under option (million)	Average exercise price £	Shares under option (million)
At 1 January	2.38	60	2.46	56	2.87	56
Granted	1.89	28	2.27	21	1.68	17
Exercised	2.44	(4)	2.46	(3)	2.37	
Cancelled	2.46	(9)	2.49	(14)	3.02	(17)
At 31 December	2.18	75	2.38	60	2.46	56

Options are exercisable within six months of vesting; 4.9 million options were exercisable at 31 December 2018 (2017 3.7 million; 2016 8.1 million). The weighted average share price at the date of exercise of options was £2.13 (2017 - £2.77; 2016 - £1.78). At 31 December 2018, exercise prices ranged from £1.68 to £3.43 (2017 - £1.68 to £4.34; 2016 - £1.68 to £4.34) and the remaining average contractual life was 2.9 years (2017 - 2.9 years; 2016 2.9 years). The fair value of options granted in 2018 was £21 million (2017 - £21 million; 2016 - £18 million).

Deferred performance awards	2018		2017		2016	
	Value at grant £m	Shares awarded (million)	Value at grant £m	Shares awarded (million)	Value at grant £m	Shares awarded (million)
At 1 January	264	101	296	102	276	80
Granted	156	59	152	63	170	75
Forfeited	(21)	(8)	(11)	(4)	(19)	(7)
Vested	(166)	(60)	(173)	(60)	(131)	(46)
At 31 December	233	92	264	101	296	102

The awards granted in 2018 vest in equal tranches on their anniversaries, predominantly over three years.

Long-term incentives

	2018			2017			2016		
	Value at grant £m	Shares awarded (million)	Options over shares (million)	Value at grant £m	Shares awarded (million)	Options over shares (million)	Value at grant £m	Shares awarded (million)	Options over shares (million)
At 1 January	102	37	2	119	38	4	153	44	5
Granted	12	5		35	15		37	16	
Vested/exercised	(5)	(2)		(22)	(7)		(39)	(12)	
Lapsed	(24)	(8)		(30)	(9)	(2)	(32)	(10)	(1)
At 31 December	85	32	2	102	37	2	119	38	4

The market value of awards vested/exercised in 2018 was £5 million (2017 - £22 million; 2016 - £40 million). There are vested options of 2 million shares exercisable up to 2020 (2017 - 2 million; 2016 - 4 million).

Notes on the consolidated accounts

3 Operating expenses continued

Variable compensation awards

The following tables analyse the Group s variable compensation awards for 2018.

	2018 £m	2017 £m	Change %
Non-deferred cash awards (1)	37	51	(27)
Total non-deferred variable compensation	37	51	(27)
Deferred bond awards	191	134	43
Deferred share awards	107	157	(32)
Total deferred variable compensation	298	291	2
Total variable compensation (2)	335	342	(2)
Variable compensation as a % of operating profit before tax (3)	9%	13%	
Proportion of variable compensation that is deferred	89%	85%	
of which			
- deferred bond awards	64%	46%	
- deferred share awards	36%	54%	

Reconciliation of variable compensation awards to income statement charge	2018 £m	2017 £m	2016 £m
Variable compensation awarded	335	342	343
Less: deferral of charge for amounts awarded for current year	(130)	(133)	(103)
Income statement charge for amounts awarded in current year	205	209	240
Add: current year charge for amounts deferred from prior years	86	96	147
Less: forfeiture of amounts deferred from prior years	(66)	(7)	(106)
Income statement charge for amounts deferred from prior years	20	89	41
Income statement charge for variable compensation (2)	225	298	281

	Actual			Expected	
Year in which income statement charge is expected to be taken for deferred variable compensation	2016 £m	2017 £m	2018 £m	2019 £m	2020 and beyond £m
Variable compensation deferred from 2016 and earlier	147	96	5	9	4
Variable compensation deferred from 2017			81	22	15
Less: forfeiture of amounts deferred from prior years	(106)	(7)	(66)		
Variable compensation for 2018 deferred				89	41
	41	89	20	120	60

Notes:

(1) Cash awards are limited to £2,000 for all employees.

(2) Excludes other performance related compensation.

(3) Operating profit before tax and variable compensation expense. This was previously measured against adjusted operating profit before variable compensation expense (2017: 7%).

Notes on the consolidated accounts

4 Segmental analysis

Reportable segments

The directors manage RBS primarily by class of business and present the segmental analysis on that basis. This includes the review of net interest income for each class of business. Interest receivable and payable for all reportable segments is therefore presented net. Segments charge market prices for services rendered between each other; funding charges between segments are determined by RBS Treasury, having regard to commercial demands. The segment performance measure is operating profit/(loss).

Reportable operating segments

In Q1 2019 and effective from 1 January 2019, Business Banking has been transferred from UK Personal and Business Bank (UK PBB) to Commercial Banking as the nature of the business, including distribution channels, products and customers, are more closely aligned to the Commercial Banking business. 2018 and comparatives have been retrospectively revised, or restated, in this Note as well as Note 3 and other segmental disclosures in Capital and risk management section. Concurrent with the transfer, the reportable operating segments have been renamed as follows:

Personal & Ulster comprises two reportable segments: UK Personal Banking and Ulster Bank RoI. UK Personal Banking serves individuals and mass affluent customers in the UK and includes Ulster Bank customers in Northern Ireland. Ulster Bank RoI serves individuals and businesses in the Republic of Ireland (RoI).

Commercial & Private Banking (CPB) comprises two reportable segments: Commercial Banking and Private Banking. Commercial Banking serves small businesses, commercial and corporate customers in the UK. Private Banking serves UK high net worth individuals and their business interests.

RBS International (RBSI) serves retail, commercial, corporate and financial institution customers in Jersey, Guernsey, Isle of Man and Gibraltar and financial institution customers in Luxembourg and London.

NatWest Markets helps global financial institutions and corporates manage their financial risks and achieve their short and long-term financial goals while navigating changing markets and regulation. NatWest Markets does this by providing global market access, financing, risk management and trading solutions from trading hubs in London, Singapore and Stamford with sales offices across key locations in the UK, EU, US and Asia.

Central items & other includes corporate functions, such as RBS Treasury, finance, risk management, compliance, legal, communications and human resources. Central functions manages RBS capital resources and RBS-wide regulatory projects and provides services to the reportable segments. Balances in relation to legacy litigation issues and the international private banking business are included in Central items in the relevant periods.

Allocation of central balance sheet items

RBS allocates all central costs relating to Services and Functions to the business using appropriate drivers, these are reported as indirect costs in the segmental income statements. Assets (and risk-weighted assets) held centrally, mainly relating to RBS Treasury, are allocated to the business using appropriate drivers.

2018	Net interest income £m	Net fees and commissions £m	Other non-interest income £m	Total income £m	Operating expenses £m	Depreciation and amortisation £m	Impairment (losses)/ releases £m	Operating profit/(loss) £m
UK Personal Banking	4,283	692	79	5,054	(2,867)		(339)	1,848
Ulster Bank RoI	444	91	75	610	(583)		(15)	12
Personal & Ulster	4,727	783	154	5,664	(3,450)		(354)	1,860
Commercial Banking	2,855	1,283	464	4,602	(2,362)	(125)	(147)	1,968
Private Banking	518	228	29	775	(476)	(2)	6	303
Commercial & Private Banking	3,373	1,511	493	5,377	(2,838)	(127)	(141)	2,271
RBS International	466	101	27	594	(254)	(6)	2	336
NatWest Markets	112	(33)	1,363	1,442	(1,589)	(15)	92	(70)
Central items & other	(22)	(5)	352	325	(783)	(583)	3	(1,038)
Total	8,656	2,357	2,389	13,402	(8,914)	(731)	(398)	3,359
2017								
UK Personal Banking	4,342	724	216	5,282	(3,241)		(207)	1,834
Ulster Bank RoI	421	94	89	604	(676)		(60)	(132)
Personal & Ulster	4,763	818	305	5,886	(3,917)		(267)	1,702
Commercial Banking	3,074	1,405	200	4,679	(2,458)	(144)	(390)	1,687
Private Banking	464	179	35	678	(529)		(6)	143
Commercial & Private Banking	3,538	1,584	235	5,357	(2,987)	(144)	(396)	1,830
RBS International	325	42	22	389	(217)	(2)	(3)	167
NatWest Markets	203	24	823	1,050	(2,250)	49	174	(977)
Central items & other	158	(13)	306	451	(222)	(711)	(1)	(483)
Total	8,987	2,455	1,691	13,133	(9,593)	(808)	(493)	2,239
2016								
UK Personal Banking	4,185	779	16	4,980	(3,675)	2	(119)	1,188
Ulster Bank RoI	409	82	85	576	(669)		113	20
Personal & Ulster	4,594	861	101	5,556	(4,344)	2	(6)	1,208
Commercial Banking	2,903	1,399	260	4,562	(2,927)	(143)	(212)	1,280
Private Banking	449	181	27	657	(549)		3	111
Commercial & Private Banking	3,352	1,580	287	5,219	(3,476)	(143)	(209)	1,391
RBS International	303	50	21	374	(174)		(10)	190
NatWest Markets	343	55	814	1,212	(2,810)	(14)	(253)	(1,865)
Central items & other	116	(11)	124	229	(4,612)	(623)		(5,006)
Total	8,708	2,535	1,347	12,590	(15,416)	(778)	(478)	(4,082)

Notes on the consolidated accounts

4 Segmental analysis continued

	2018			2017			2016		
	External	Inter segment	Total	External	Inter segment	Total	External	Inter segment	Total
Total revenue	£m	£m	£m	£m	£m	£m	£m	£m	£m
UK Personal Banking	6,188	63	6,251	6,406	39	6,445	6,303	50	6,353
Ulster Bank RoI	668		668	676	(4)	672	660	1	661
Personal & Ulster	6,856	63	6,919	7,082	35	7,117	6,963	51	7,014
Commercial Banking	4,576	89	4,665	4,532	79	4,611	4,532	70	4,602
Private Banking	681	195	876	585	143	728	567	172	739
Commercial & Private Banking	5,257	284	5,541	5,117	222	5,339	5,099	242	5,341
RBS International	506	148	654	309	119	428	313	156	469
NatWest Markets	1,882	916	2,798	1,408	809	2,217	1,708	1,539	3,247
Central items & other	2,155	(1,411)	744	2,147	(1,185)	962	1,862	(1,988)	(126)
Total	16,656		16,656	16,063		16,063	15,945		15,945
Total income									
UK Personal Banking	5,021	33	5,054	5,265	17	5,282	4,953	27	4,980
Ulster Bank RoI	613	(3)	610	609	(5)	604	584	(8)	576
Personal & Ulster	5,634	30	5,664	5,874	12	5,886	5,537	19	5,556
Commercial Banking	5,079	(477)	4,602	5,051	(372)	4,679	4,949	(387)	4,562
Private Banking	655	120	775	594	84	678	554	103	657
Commercial & Private Banking	5,734	(357)	5,377	5,645	(288)	5,357	5,503	(284)	5,219
RBS International	469	125	594	281	108	389	239	135	374
NatWest Markets	1,510	(68)	1,442	1,077	(27)	1,050	1,296	(84)	1,212
Central items & other	55	270	325	256	195	451	15	214	229
Total	13,402		13,402	13,133		13,133	12,590		12,590

Analysis of net fees and commissions 2018	UK PB £m	Ulster Bank RoI £m	Commercial Banking £m	Private Banking £m	RBS International £m	NatWest Markets £m	Central items & other £m	Total £m
Fees and commissions receivable								
- Payment services	227	34	556	33	25	3		878
- Credit and debit card fees	402	22	175	13				612
- Lending (credit facilities)	408	29	415	2	29	88		971
- Brokerage	62	6		5		85		158
- Investment management, trustee and fiduciary services	49	4		191	42			286
- Trade finance		2	122	1	4	3		132

- Underwriting fees	13		17			144		174
- Other	2	1	60	16	2	67	(141)	7
Total	1,163	98	1,345	261	102	390	(141)	3,218
Fees and commissions payable	(471)	(7)	(62)	(33)	(1)	(423)	136	(861)
Net fees and commissions	692	91	1,283	228	101	(33)	(5)	2,357
2017								
Fees and commissions receivable								
- Payment services	194	30	543	37	24	1		829
- Credit and debit card fees	451	27	175	12				665
- Lending (credit facilities)	436	30	497	2	10	83	2	1,060
- Brokerage	69	10		6		63		148
- Investment management, trustee and fiduciary services	72	4	35	133	4	1		249
- Trade finance		2	164	1	3	3		173
- Underwriting fees						157		157
- Other	1		51	15	2	132	(144)	57
Total	1,223	103	1,465	206	43	440	(142)	3,338
Fees and commissions payable	(499)	(9)	(60)	(27)	(1)	(416)	129	(883)
Net fees and commissions	724	94	1,405	179	42	24	(13)	2,455

Notes on the consolidated accounts

4 Segmental analysis continued

2016	UK PB £m	Ulster Bank RoI £m	Commercial Banking £m	Private Banking £m	RBS International £m	NatWest Markets £m	Central items & other £m	Total £m
Fees and commissions receivable								
- Payment services	215	27	534	32	24	24		856
- Credit and debit card fees	437	25	163	18	2			645
- Lending (credit facilities)	416	30	490	2	11	95		1,044
- Brokerage	63	7	1	7	1	71	4	154
- Investment management, trustee and fiduciary services	84	3	37	118	(3)		11	250
- Trade finance		2	158	1	5	30		196
- Underwriting fees						83		83
- Other	4		68	28	21	202	(211)	112
Total	1,219	94	1,451	206	61	505	(196)	3,340
Fees and commissions payable	(440)	(12)	(52)	(25)	(11)	(450)	185	(805)
Net fees and commissions	779	82	1,399	181	50	55	(11)	2,535

	2018		2017		2016	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	Assets £m	Liabilities £m
UK Personal Banking	171,011	148,792	166,560	145,104	157,296	136,744
Ulster Bank RoI	25,193	21,189	24,564	19,853	24,111	19,299
Personal & Ulster	196,204	169,981	191,124	164,957	181,407	156,043
Commercial Banking	166,478	139,804	173,621	143,450	174,514	140,737
Private Banking	21,983	28,554	20,290	27,049	18,578	26,673
Commercial & Private Banking	188,461	168,358	193,911	170,499	193,092	167,410
RBS International	28,398	27,663	25,867	29,077	23,420	25,280
NatWest Markets	244,531	227,399	277,886	248,553	372,496	340,471
Central items & other	36,641	54,344	49,268	75,877	28,241	60,048
Total	694,235	647,745	738,056	688,963	798,656	749,252

Segmental analysis of goodwill is as follows:

	UK Personal Banking £m	Commercial & Private Banking £m	RBS International £m	Total £m
At 1 January 2017 and 31 December 2017	2,651	2,607	300	5,558
Acquisitions	48			48
Inter-segment transfers	(9)	9		
At 31 December 2018	2,690	2,616	300	5,606

Notes on the consolidated accounts

4 Segmental analysis continued

Geographical segments

The geographical analysis in the tables below has been compiled on the basis of location of office where the transactions are recorded.

2018	UK £m	USA £m	Europe £m	RoW £m	Total £m
Total revenue	15,351	300	838	167	16,656
Net interest income	8,223		404	29	8,656
Net fees and commissions	2,183	12	102	60	2,357
Income from trading activities	1,308	124	68	7	1,507
Other operating income	467	119	229	67	882
Total income	12,181	255	803	163	13,402
Operating profit/(loss) before tax	3,805	(718)	150	122	3,359
Total assets	624,228	32,573	34,441	2,993	694,235
Total liabilities	588,185	31,329	27,183	1,048	647,745
Net assets attributable to equity owners and non-controlling interests	36,043	1,244	7,258	1,945	46,490
Contingent liabilities and commitments	121,267		5,408	208	126,883
2017					
Total revenue	15,011	192	655	205	16,063
Net interest income	8,611	(4)	346	34	8,987
Net fees and commissions	2,192	97	113	53	2,455
Income from trading activities	570	83	(24)	5	634
Other operating income	806	22	121	108	1,057
Total income	12,179	198	556	200	13,133
Operating profit/(loss) before tax	3,230	(580)	(485)	74	2,239
Total assets	662,314	38,485	34,280	2,977	738,056
Total liabilities	626,103	36,564	25,171	1,125	688,963
Net assets attributable to equity owners and non-controlling interests	36,211	1,921	9,109	1,852	49,093
Contingent liabilities and commitments	128,127	78	7,823	22	136,050
2016					
Total revenue	14,606	264	738	337	15,945
Net interest income	8,243	82	302	81	8,708
Net fees and commissions	2,287	9	175	64	2,535
Income from trading activities	790	159	18	7	974
Other operating income	261	(40)	9	143	373
Total income	11,581	210	504	295	12,590

Operating (loss)/profit before tax	(2,214)	(1,652)	(266)	50	(4,082)
Total assets	715,685	44,447	32,142	6,382	798,656
Total liabilities	675,089	44,513	26,311	3,339	749,252
Net assets attributable to equity owners and non-controlling interests	40,596	(66)	5,831	3,043	49,404
Contingent liabilities and commitments	141,963	639	8,038	51	150,691

Notes on the consolidated accounts

5 Pensions

Defined contribution schemes

The Group sponsors a number of defined contribution pension schemes in different territories, which new employees are offered the opportunity to join.

Defined benefit schemes

The Group sponsors a number of pension schemes in the UK and overseas, including the Main section of The Royal Bank of Scotland Group Pension Fund (the Main section) which operates under UK trust law and is managed and administered on behalf of its members in accordance with the terms of the trust deed, the scheme rules and UK legislation.

Pension fund trustees are appointed to operate each fund and ensure benefits are paid in accordance with the scheme rules and national law. The trustees are the legal owner of a scheme s assets, and have a duty to act in the best interests of all scheme members.

The schemes generally provide a pension of one-sixtieth of final pensionable salary for each year of service prior to retirement up to a maximum of 40 years and are contributory for current members. These have been closed to new entrants for over ten years, although current members continue to build up additional pension benefits, currently subject to 2% maximum annual salary inflation, while they remain employed by the Group.

The Main section corporate trustee is RBS Pension Trustee Limited (the Trustee), a wholly owned subsidiary of National Westminster Bank Plc, Principal Employer of the Main section. The Board of the Trustee comprises four member trustee directors selected from eligible active staff, deferred and pensioner members who apply and six appointed by the Group. Under UK legislation a defined benefit pension scheme is required to meet the statutory funding objective of having sufficient and appropriate assets to cover its liabilities (the pensions that have been promised to members).

Similar governance principles apply to the Group s other pension schemes.

Investment strategy

The assets of the Main section, which is typical of other group schemes, represent 90% of plan assets at 31 December 2018 (2017 - 90%) and are invested in a diversified portfolio as shown below.

The Main section employs derivative instruments to achieve a desired asset class exposure and to reduce the section s interest rate, inflation and currency risk. This means that the net funding position is considerably less sensitive to changes in market conditions than the value of the assets or liabilities in isolation.

	2018			2017		
Major classes of plan assets as a percentage of total plan assets of the Main section	Quoted %	Unquoted %	Total %	Quoted %	Unquoted %	Total %
Equities	3.7%	5.2%	8.9%	21.9%	4.0%	25.9%
Index linked bonds	40.1%		40.1%	30.6%		30.6%
Government bonds	12.9%		12.9%	9.2%		9.2%
Corporate and other bonds	12.2%	5.2%	17.4%	15.8%	1.0%	16.8%
Real estate		5.5%	5.5%		5.2%	5.2%
Derivatives		6.1%	6.1%		8.1%	8.1%
Cash and other assets		9.1%	9.1%		4.2%	4.2%
	68.9%	31.1%	100.0%	77.5%	22.5%	100.0%

The Main section s holdings of derivative instruments are summarised in the table below:

	2018			2017		
	Notional amounts	Fair value		Notional amounts	Fair value	
		Assets	Liabilities		Assets	Liabilities
	£bn	£m	£m	£bn	£m	£m
Inflation rate swaps	13	347	502	11	310	555
Interest rate swaps	55	8,132	5,362	44	8,161	4,779
Currency forwards	10	22	164	12	160	34
Equity and bond call options	1	277		2	428	
Equity and bond put options	4	3	1	3	3	1
Other	4	1,027	1,092	4	327	444

Swaps have been executed at prevailing market rates and within standard market bid/offer spreads with a number of counterparty banks, including NatWest Markets Plc.

At 31 December 2018, the gross notional value of the swaps was £72 billion (2017 - £57 billion) and had a net positive fair value of £2,557 million (2017 - £3,045 million) against which the banks had posted approximately 103% collateral.

The schemes do not invest directly in the Group but can have exposure to the Group. The trustees of the respective UK schemes are responsible for ensuring that indirect investments in the Group do not exceed the 5% regulatory limit.

Notes on the consolidated accounts

5 Pensions continued

	Main section				All schemes			
	Fair value of plan assets	Present value of defined benefit obligation	Asset ceiling/ minimum funding (1)	Net pension liability/ (asset)	Fair value of plan assets	Present value of defined benefit obligation	Asset ceiling/ minimum funding (1)	Net pension liability/ (asset)
Changes in value of net pension liability/(asset)	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January 2017	43,824	38,851	4,973		49,229	43,990	5,326	87
Currency translation and other adjustments					46	46	3	3
Income statement	1,155	1,266	134	245	1,285	1,518	142	375
Statement of comprehensive income	1,580	(9)	1,608	19	1,728	4	1,634	(90)
Contributions by employer	264			(264)	627			(627)
Contributions by plan participants and other scheme members	4	4			10	10		
Liabilities extinguished upon settlement					(744)	(755)		(11)
Benefits paid	(2,175)	(2,175)			(2,435)	(2,435)		
At 1 January 2018	44,652	37,937	6,715		49,746	42,378	7,105	(263)
Currency translation and other adjustments					20	17	(1)	(4)
Income statement								
Net interest expense	1,123	939	171	(13)	1,242	1,043	179	(20)
Current service cost		190		190		240		240
Past service cost		14		14		14		14
Loss on curtailments or settlements						74		74
	1,123	1,143	171	191	1,242	1,371	179	308
Statement of comprehensive income								
Return on plan assets excluding recognised interest income	(1,891)			1,891	(2,090)			2,090
Experience gains and losses		122		122		81		81
Effect of changes in actuarial financial assumptions		(2,338)		(2,338)		(2,537)		(2,537)
Effect of changes in actuarial demographic assumptions		820		820		826		826
Asset ceiling adjustments:								
Attributable to contributions required by ring fencing			2,000	2,000			2,053	2,053
Other movements in the year			(468)	(468)			(546)	(546)
	(1,891)	(1,396)	1,532	2,027	(2,090)	(1,630)	1,507	1,967
Contributions by employer	2,218			(2,218)	2,363			(2,363)
Contributions by plan participants and other scheme members	7	7			12	12		
Liabilities extinguished upon settlement					(259)	(259)		
	(276)	(198)	(78)					

Transfer of pension assets and liabilities from Main section (2)							
Benefits paid	(2,027)	(2,027)		(2,282)	(2,282)		
At 31 December 2018	43,806	35,466	8,340	48,752	39,607	8,790	(355)

Notes:

(1) The group recognises the net pension scheme surplus or deficit as a net asset or liability. In doing so, the funded status is adjusted to reflect any schemes with a surplus that the Group may not be able to access, as well as any minimum funding requirement to pay in additional contributions. This is most relevant to the Main section, where the surplus is not recognised.

(2) Includes adjustment for assets of £276 million and liabilities of £198 million transferred at no consideration to establish two separate sections of the RBS Group Pension Fund because ring-fencing rules do not allow employees outside the ring-fenced group to be members of the Main section.

(3) The Group expects to make contributions to the Main section of £218 million in 2019.

	All schemes	
	2018	2017
Amounts recognised on the balance sheet	£m	£m
Fund assets at fair value	48,752	49,746
Present value of fund liabilities	39,607	42,378
Funded status	9,145	7,368
Asset ceiling/minimum funding	8,790	7,105
	355	263

	2018	2017
Net pension asset/(liability) comprises	£m	£m
Net assets of schemes in surplus (included in Other assets, Note 17)	520	392
Net liabilities of schemes in deficit (included in Other liabilities, Note 20)	(165)	(129)
	355	263

Notes on the consolidated accounts

5 Pensions continued

Funding and contributions by the Group

In the UK, the trustees of defined benefit pension schemes are required to perform funding valuations every three years. The trustees and the sponsor, with the support of the Scheme Actuary, agree the assumptions used to value the liabilities and a Schedule of Contributions required to eliminate any funding deficit. The funding assumptions incorporate a margin for prudence over and above the expected cost of providing the benefits promised to members, taking into account the sponsor s covenant and the investment strategy of the scheme. Similar arrangements apply in the other territories where the Group sponsors defined benefit pension schemes. The last funding valuation of the Main section was at 31 December 2017 and next funding valuation is due at 31 December 2020, to be agreed by 31 March 2022.

The triennial funding valuation of the Main section as at 31 December 2017 determined the funding level to be 96%, pension liabilities to be £47 billion and the deficit to be £2 billion, which was eliminated by a £2 billion cash payment in October 2018. The average cost of the future service of current members is 44% of basic salary before administrative expenses and contributions from those members.

In October 2018 the Court ruled on the requirement to and method for equalising guaranteed minimum pension benefits arising between 1990 and 1997 between men and women. In 2017 the Group considered that equalisation would change the Main section s defined benefit obligation by 0.2%.The estimate was updated following the clarity provided by the Court ruling and the impact of any future conversion exercise to rectify the position. The £102 million cost on revision of the previous estimate of the financial assumptions in respect of equalisation is recognised in equity.

Assumptions

Placing a value on the Group s defined benefit pension schemes liabilities requires the Group s management to make a number of assumptions, with the support of independent actuaries. The ultimate cost of the defined benefit obligations depends upon actual future events and the assumptions made are unlikely to be exactly borne out in practice, meaning the final cost may be higher or lower than expected.

The most significant assumptions used for the Main section are shown below:

	Principal IAS 19 actuarial assumptions		Principal assumptions of 2017 triennial valuation
	2018	2017	2017
	%	%	
Discount rate	2.9	2.6	Fixed interest swap yield curve plus 0.8% per annum
Inflation assumption (RPI)	3.2	3.1	RPI swap yield curve
Rate of increase in salaries	1.8	1.8	

Rate of increase in deferred pensions	3.1	3.0	
Rate of increase in pensions in payment	2.9	2.9	Modelled allowance for relevant caps and floors
Lump sum conversion rate at retirement	20	21	18%
Longevity at age 60:	years	years	
Current pensioners			
Males	27.2	27.2	28.1
Females	29.0	28.7	29.7
Future pensioners, currently aged 40			
Males	28.4	28.6	29.3
Females	30.5	30.4	31.5

Discount rate

The IAS 19 valuation uses a single discount rate by reference to the yield on a basket of high quality sterling corporate bonds. For the triennial valuation discounting is by reference to a yield curve.

The weighted average duration of the Main section s defined benefit obligation at 31 December 2018 is 20 years (2017 21 years).

Significant judgement is required when setting the criteria for bonds to be included in IAS 19 s basket of bonds that is used to determine the discount rate used in the valuations. The criteria include issue size, quality of pricing and the exclusion of outliers. Judgement is also required in determining the shape of the yield curve at long durations: a constant credit spread relative to gilts is assumed. Sensitivity to the main assumptions is presented below.

Notes on the consolidated accounts

5 Pensions continued

The chart below shows the projected benefit payment pattern for the Main section in nominal terms. These cashflows are based on the most recent formal actuarial valuation, effective 31 December 2017.

The larger outflow in the first four years represents the expected level of transfers out to 31 December 2021.

The table below shows how the present value of the defined benefit obligation of the Main section would change if the key assumptions used were changed independently. In practice the variables are somewhat correlated and do not move completely in isolation.

2018	(Decrease)/increase in value of assets £m	(Decrease)/increase in value of liabilities £m	Increase in net pension assets/ (obligations) £m
0.25% increase in interest rates/discount rate	(2,214)	(1,644)	(570)
0.25% increase in inflation	1,487	1,199	288
0.25% increase in credit spreads	(5)	(1,644)	1,639
Longevity increase of one year		1,414	(1,414)
0.25% additional rate of increase in pensions in payment		1,215	(1,215)
Increase in equity values of 10% (1)	419		419
2017			
0.25% increase in interest rates/discount rate	(2,218)	(1,964)	(254)
0.25% increase in inflation	1,289	1,329	(40)
0.25% increase in credit spreads	(7)	(1,964)	1,957
Longevity increase of one year		1,478	(1,478)
0.25% additional rate of increase in pensions in payment		1,328	(1,328)
Increase in equity values of 10% (1)	909		909

Note:

(1) Includes both quoted and private equity.

Notes on the consolidated accounts

5 Pensions continued

The defined benefit obligation of the Main section is attributable to the different classes of scheme members in the following proportions:

Membership category	2018 %	2017 %
Active members	12.9	16.2
Deferred members	48.6	47.3
Pensioners and dependants	38.5	36.5
	100.0	100.0

The experience history of Group schemes is shown below:

	Main section					All schemes				
History of defined benefit schemes	2018 £m	2017 £m	2016 £m	2015 £m	2014 £m	2018 £m	2017 £m	2016 £m	2015 £m	2014 £m
Fair value of plan assets	43,806	44,652	43,824	30,703	30,077	48,752	49,746	49,229	34,708	34,359
Present value of plan obligations	35,466	37,937	38,851	30,966	31,776	39,607	42,378	43,990	35,152	36,643
Net surplus/(deficit)	8,340	6,715	4,973	(263)	(1,699)	9,145	7,368	5,239	(444)	(2,284)
Experience (losses)/gains on plan liabilities	(122)	(107)	658	233	3	(81)	(93)	794	258	18
Experience (losses)/gains on plan assets	(1,891)	1,580	8,562	(415)	4,629	(2,090)	1,728	9,254	(458)	5,171
Actual return on plan assets	(768)	2,735	9,872	703	5,766	(848)	3,013	10,708	749	6,485
Actual return on plan assets - %	(1.7%)	6.2%	32.2%	2.3%	23.8%	(1.7%)	6.1%	30.9%	2.2%	22.8%

6 Auditor s remuneration

Amounts paid to the Group s auditors for statutory audit and other services are set out below. All audit-related and other services are approved by the Group Audit Committee and are subject to strict controls to ensure the external auditor s independence is unaffected by the provision of other services. The Group Audit Committee recognises that for certain assignments the auditors are best placed to perform the work economically; for other work the Group selects the supplier best placed to meet its requirements. The Group s auditors are permitted to tender for such work in competition with other firms where the work is permissible under audit independence rules.

Amounts paid to the Group s auditors for statutory audit and other services are set out below:

	2018 £m	2017 £m	2016 £m
Fees payable for the audit of the Group s annual accounts(1)	3.5	4.0	4.0
- the audit of the company s subsidiaries(1)	27.5	22.9	20.7
- audit-related assurance services (1,2)	2.9	4.3	4.0
Total audit and audit-related assurance services fees	33.9	31.2	28.7
Other assurance services	1.3	1.7	3.4
Corporate finance services (3)	0.2	0.2	0.2
Non-audit services			
Total other services	1.5	1.9	3.6

Notes:

(1) The 2018 audit fee was approved by the Group Audit Committee. At 31 December 2018, £16 million has been billed in and paid in respect of 2018 Group audit fees.

(2) Comprises fees of £1.1 million (2017 - £1.1 million) in relation to reviews of interim financial information, £1.1 million (2017 - £2.5 million) in respect of reports to the Group s regulators in the UK and overseas, £0.7 million (2017 - £0.7 million) in relation to non-statutory audit opinions.

(3) Comprises fees of £0.2 million (FY 2017 - £0.2 million) in respect of work performed by the auditors as reporting accountants on debt and equity issuances undertaken by the Group.

Notes on the consolidated accounts

7 Tax

Changes in reporting standards

IAS 12 Income taxes was revised with effect from 1 January 2019. The income statement is now required to include any tax relief on the servicing cost of instruments classified as equity. Relief of £67 million (2017 - £93 million; 2016 - £59 million) was recognised in the statement of changes in equity for the year ended 31 December 2018; this and prior periods have been retrospectively revised, or restated, in this Note, Note 36 Consolidating financial information, consolidated Income statement, statement of comprehensive income and statement of changes in equity.

	2018 £m	2017 £m	2016 £m
Current tax:			
Charge for the year	(1,025)	(925)	(1,067)
Over provision in respect of prior years	125	227	186
	(900)	(698)	(881)
Deferred tax:			
(Charge)/credit for the year	(280)	108	246
Increase/(reduction) in the carrying value of deferred tax assets	7	(30)	(317)
Under provision in respect of prior years	(35)	(111)	(155)
Tax charge for the year	(1,208)	(731)	(1,107)

The actual tax charge differs from the expected tax (charge)/credit computed by applying the standard rate of UK corporation tax of 19% (2017 19.25%; 2016 20.00%) as follows:

	2018 £m	2017 £m	2016 £m
Expected tax (charge)/credit	(638)	(431)	816
Losses and temporary differences in year where no deferred tax asset recognised	(55)	(303)	(742)
Foreign profits taxed at other rates	(8)	104	340
UK tax rate change impact (1)		(7)	6
Items not allowed for tax:			
- losses on disposals and write-downs	(44)	(69)	(45)
- UK bank levy	(38)	(45)	(41)
- regulatory and legal actions	(203)	(56)	(952)
- other disallowable items	(63)	(110)	(141)
Non-taxable items	47	134	136
Taxable foreign exchange movements	(27)	27	(57)
Losses brought forward and utilised	14	11	10
Increase/(reduction) in carrying value of deferred tax asset in respect of:			
- UK losses	7	(30)	(317)
Banking surcharge	(357)	(165)	(210)
Adjustments in respect of prior years (2)	90	116	31
Tax credit on paid-in equity	67	93	59
Actual tax charge	(1,208)	(731)	(1,107)

Notes:

(1) In recent years, the UK government has steadily reduced the rate of UK corporation tax, with the latest enacted rates standing at 19% from 1 April 2017 and 17% from 1 April 2020.

(2) Prior year tax adjustments incorporate refinements to tax computations made on submission and agreement with the tax authorities. Current taxation balances include provisions in respect of uncertain tax positions, in particular in relation to restructuring and other costs where the taxation treatment remains subject to agreement with the relevant tax authorities.

Judgment: Tax contingencies

The Group s income tax charge and its provisions for income taxes necessarily involve a degree of estimation and judgement. The tax treatment of some transactions is uncertain and tax computations are yet to be agreed with the tax authorities in a number of jurisdictions. The Group recognises anticipated tax liabilities based on all available evidence and, where appropriate, in the light of external advice. Any difference between the final outcome and the amounts provided will affect current and deferred income tax charges in the period when the matter is resolved.

Deferred tax

	2018 £m	2017 £m
Deferred tax asset	(1,412)	(1,740)
Deferred tax liability	454	583
Net deferred tax asset	(958)	(1,157)

Notes on the consolidated accounts

7 Tax continued

Net deferred tax asset comprised:

	Pension £m	Accelerated capital allowances £m	Expense provisions £m	Financial instruments £m	Tax losses carried forward £m	Other £m	Total £m
At 1 January 2017	(662)	361	(322)	395	(1,050)	137	(1,141)
Acquisitions and disposals of subsidiaries		(29)					(29)
Charge/(credit) to income statement	3	(126)	55	46	121	(66)	33
Charge/(credit) to other comprehensive income	266			(243)		(19)	4
Currency translation and other adjustments		(14)	1		(10)	(1)	(24)
At 1 January 2018	(393)	192	(266)	198	(939)	51	(1,157)
Implementation of IFRS9 on 1 January 2018				16			16
(Credit)/charge to income statement	(40)	22	121	154	5	46	308
(Credit)/charge to other comprehensive income	(95)	1		(23)		33	(84)
Currency translation and other adjustments		5	(14)	4	(2)	(34)	(41)
At 31 December 2018	(528)	220	(159)	349	(936)	96	(958)

Deferred tax assets in respect of unused tax losses are recognised if the losses can be used to offset probable future taxable profits after taking into account the expected reversal of other temporary differences. Recognised deferred tax assets in respect of tax losses are analysed further below.

	2018 £m	2017 £m
UK tax losses carried forward		
- NatWest Markets Plc	151	125
- National Westminster Bank Plc	505	541
- Ulster Bank Limited	19	14
Total	675	680
Overseas tax losses carried forward		
- Ulster Bank Ireland DAC	261	259
	936	939

Critical accounting policy: Deferred Tax

The deferred tax assets of £1,412 million at 31 December 2018 (2017 - £1,740 million) principally comprise losses that arose in the UK, and temporary differences. These deferred tax assets are recognised to the extent that it is probable that there will be future taxable profits to recover them.

Judgment - The Group has considered the carrying value of deferred tax assets and concluded that, based on management s estimates, sufficient taxable profits will be generated in future years to recover recognised deferred tax assets.

Estimate **-**These estimates are partly based on forecast performance beyond the horizon for management s detailed plans. They have regard to inherent uncertainties, such as Brexit and climate change.

UK tax losses - Under UK tax rules, tax losses can be carried forward indefinitely. As the recognised tax losses in the Group arose prior to 1 April 2015, credit in future periods is given against 25% of profits at the main rate of UK corporation tax, excluding the Banking Surcharge 8% rate introduced by The Finance (No. 2) Act 2015. Deferred tax assets and liabilities at 31 December 2018 take into account the reduced rates in respect of tax losses and temporary differences and where appropriate, the banking surcharge inclusive rate in respect of other banking temporary differences.

NatWest Markets Plc NatWest Markets Plc expects that the balance of recognised deferred tax asset at 31 December 2018 of £151 million in respect of tax losses amounting to approximately £800 million will be recovered by the end of 2024. Since 2012 NatWest Markets Plc has reported mixed levels of taxable profits and losses because core banking profitability was offset by a series of restructuring plans as the group reshaped to meet commercial and regulatory demands. In total, £10.2 billion of losses have not been recognised in the deferred tax balance at 31 December 2018; such losses will be available to offset 25% of future taxable profits in excess of those forecast in the closing deferred tax asset.

National Westminster Bank Plc A deferred tax asset of £505 million has been recognised in respect of total losses of £2,936 million. The losses arose principally as a result of significant impairment and conduct charges between 2009 and 2012 during challenging economic conditions in the UK banking sector. National Westminster Bank plc returned to tax profitability during 2015 and expects the deferred tax asset to be consumed by future taxable profits by the end of 2023.

Notes on the consolidated accounts

7 Tax continued

Overseas tax losses

Ulster Bank Ireland DAC A deferred tax asset of £261 million has been recognised in respect of losses of £2,089 million of total losses of £8,855 million carried forward at 31 December 2018. The losses arose principally as a result of significant impairment charges between 2008 and 2013 during challenging economic conditions in the Republic of Ireland. Subsequent movements reflect the £: exchange differences. As UBIDAC continues to operate in a small open economy subject to short term volatility and extended non-performing loan realisation periods the company expects, in assessing its deferred tax asset on tax losses, that they will be consumed by future taxable profits by the end of 2027.

Unrecognised deferred tax

Deferred tax assets of £5,118 million (2017 - £6,356 million; 2016 - £7,940, million) have not been recognised in respect of tax losses and other temporary differences carried forward of £25,597 million (2017 - £30,049 million; 2016 - £33,376 million) in jurisdictions where doubt exists over the availability of future taxable profits. Of these losses and other temporary differences, £939 million expire within five years and £5,992 million thereafter. The balance of tax losses and other temporary differences carried forward has no expiry date.

Deferred tax liabilities of £257 million (2017 - £255 million; 2016 - £258 million) have not been recognised in respect of retained earnings of overseas subsidiaries and held-over gains on the incorporation of overseas branches. Retained earnings of overseas subsidiaries are expected to be reinvested indefinitely or remitted to the UK free from further taxation. No taxation is expected to arise in the foreseeable future in respect of held-over gains. Changes to UK tax legislation largely exempts from UK tax, overseas dividends received on or after 1 July 2009.

8 Earnings per share

	2018 £m	2017 £m	2016 £m
Earnings			
Profit/(loss) attributable to ordinary shareholders	1,622	752	(6,955)
Weighted average number of shares (millions)			
Weighted average number of ordinary shares outstanding during the year	12,009	11,867	11,692
Effect of dilutive share options and convertible securities	52	69	51
Diluted weighted average number of ordinary shares outstanding during the year	12,061	11,936	11,743

9 Trading assets and liabilities

Trading assets and liabilities comprise assets and liabilities held at fair value in trading portfolios.

Assets	2018 £m	2017 £m
Loans		
Reverse repos	24,759	36,272
Collateral given	19,036	21,558

Other loans	1,308	651
Total loans	45,103	58,481
Securities		
Central and local government		
- UK	6,834	3,514
- US	4,689	3,667
- other	13,498	14,736
Other securities	4,995	5,593
Total securities	30,016	27,510
Total	75,119	85,991
Liabilities		
Deposits		
Repos	25,645	28,363
Collateral received	20,187	22,683
Other deposits	1,788	1,302
Total deposits	47,620	52,348
Debt securities in issue	903	1,107
Short positions	23,827	28,527
Total	72,350	81,982

Notes on the consolidated accounts

10 Derivatives

Companies within RBS transact derivatives as principal either as a trading activity or to manage balance sheet foreign exchange, interest rate and credit risk.

	2018			2017		
	Notional amount £bn	Assets £m	Liabilities £m	Notional amount £bn	Assets £m	Liabilities £m
Exchange rate contracts	3,426	36,545	38,230	3,425	39,211	41,681
Interest rate contracts	10,536	96,410	90,444	12,016	120,945	112,160
Credit derivatives	16	346	208	38	531	558
Equity and commodity contracts	1	48	15	3	156	107
		133,349	128,897		160,843	154,506

RBS enters into fair value hedges, cash flow hedges and hedges of net investments in foreign operations. The majority of RBS s interest rate hedges relate to the management of RBS s non-trading interest rate risk. RBS manages this risk within approved limits. Residual risk positions are hedged with derivatives principally interest rate swaps. Suitable larger financial instruments are fair value hedged; the remaining exposure, where possible, is hedged by derivatives documented as cash flow hedges.

The majority of RBS s fair value hedges involve interest rate swaps hedging the fixed interest rate risk in recognised financial assets and financial liabilities. Cash flow hedges relate to exposures to the variability in future interest payments and receipts due to the movement of benchmark interest rates or foreign exchange rates on forecast transactions and on recognised financial assets and financial liabilities. This variability in cash flows is hedged by interest rate swaps and forward foreign exchange contracts. RBS hedges its net investments in foreign operations with currency borrowings and forward foreign exchange contracts.

For cash flow hedge relationships of interest rate risk, the hedged items are actual and forecast variable interest rate cash flows arising from financial assets and financial liabilities with interest rates linked to the relevant benchmark rate LIBOR, EURIBOR or the Bank of England Official Bank Rate. The financial assets are loans to banks and customer and the financial liabilities are bank and customer deposits and LIBOR linked medium-term notes and other issued securities. The variability in cash flows due to movements in the relevant benchmark rate is hedged; this risk component is identified using the risk management systems of RBS. This risk component comprises the majority of cash flow variability risk.

For cash flow hedging relationships RBS determines that there is an economic relationship between the hedged item and hedging instrument via assessing the initial and ongoing effectiveness by comparing movements in the fair value of the expected highly probable forecast interest cash flows with movements in the fair value of the expected changes in cash flows from the hedging interest rate swap. Hedge effectiveness is measured on a cumulative basis over a time period management determines to be appropriate. The method of calculating hedge ineffectiveness is the hypothetical derivative method. RBS uses the actual ratio between the hedged item and hedging instrument to establish the hedge ratio for hedge accounting. For fair value hedge relationships of interest rate risk, the hedged items are typically large corporate fixed-rate loans, government securities, fixed rate finance leases, fixed rate medium-term notes or preference shares classified as debt. The hedged risk is the risk of changes in the hedged items fair value attributable to changes in the benchmark interest rate embedded in the hedged item. This risk component is identified using the risk management systems of RBS. This risk component comprises the majority of the hedged items fair value risk.

For fair value hedge relationships RBS determines that there is an economic relationship between the hedged items and hedging instrument via assessing the initial and ongoing effectiveness by comparing movements in the fair value of the hedged item attributable to the hedged risk with movements in the fair value of the expected changes in cash flows from the hedging interest rate swap. Hedge effectiveness is measured on a cumulative basis over a time period management determines to be appropriate. RBS uses either the actual ratio between the hedged item and hedging instrument(s) or one that minimises hedge ineffectiveness to establish the hedge ratio for hedge accounting. RBS hedges the currency risk of its net investment in foreign currency denominated operations with currency borrowings and forward foreign exchange contracts. RBS reviews the value of the investments net assets, executing hedges where appropriate to reduce the sensitivity of capital ratios to foreign exchange rate movement.

The Group hedges currency risk in respect of its net investment in foreign currency denominated operations with currency borrowings and forward foreign exchange contracts. The Group reviews the value of the investments net assets, executing hedges where appropriate, to reduce the sensitivity of capital ratios to foreign exchange movements.

Included in the table above are derivatives held for hedging purposes as follows:

	2018			2017	
	Notional £bn	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Fair value hedging					
Interest rate contracts	60.0	965	2,061	904	2,211
Cash flow hedging					
Interest rate contracts	149.7	1,148	872	1,989	1,295
Exchange rate contacts	12.5	106		63	37
Net investment hedging					
Exchange rate contracts	2.0	32	10	11	28
	224.2	2,251	2,943	2,967	3,571

Notes on the consolidated accounts

10 Derivatives continued

The following table shows the period in which the hedging contract ends:

	0-3 months	3-12 months	1-3 years	3-5 years	5-10 years	10-20 years	20+ years	Total
Fair value hedging								
Hedging assets - Interest rate risk (£bn)	1.0	1.8	11.0	4.9	7.8	3.7	3.8	34.0
Hedging liabilities - Interest rate risk (£bn)		2.0	7.5	10.0	4.6	1.9		26.0
Cash flow hedging								
Hedging assets								
Interest rate risk (£bn)	3.9	10.9	47.8	8.7	10.5			81.8
Average fixed interest rate	1.87	1.44	1.13	2.00	1.43			1.33
Hedging liabilities								
Interest rate risk (£bn)	8.6	18.9	34.1	5.1	0.4	0.8		67.9
Average fixed interest rate	0.54	0.56	1.07	1.34	3.96	4.31		0.94
Exchange rate risk (£bn)			5.8	4.7	2.0			12.5
Average USD - £ rate			1.32	1.37	1.50			1.37
Net investment hedging								
Exchange rate risk (£bn)	1.2	0.6	0.2					2.0
Principal currency hedges								
Average SAR - £ rate	4.80	4.83	4.82					4.81
Average CHF - £ rate	1.22	1.23	1.18					1.21

The table below analyses assets and liabilities subject to hedging derivatives.

2018	Carrying value (CV) of hedged assets and liabilities £m	Impact on hedged items included in CV £m	Impact on hedged items ceased to be adjusted for hedging gains or losses £m
Fair value hedging - interest rate			
Loans to banks and customers - amortised cost	6,197	875	91
Other financial assets - securities	31,879	362	10
Total	38,076	1,237	101
Other financial liabilities - debt securities in issue	23,289	(19)	
Subordinated liabilities	2,359	22	
Total	25,648	3	
Fair value hedging - exchange rate			
Other financial assets - securities	3		
Cash flow hedging - interest rate			
Loans to banks and customers - amortised cost	81,880		
Bank and customer deposits	67,854		

Cash flow hedging - exchange rate	
Other financial liabilities - debt securities in issue	5,590
Subordinates liabilities	6,902
Total	12,492

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Notes on the consolidated accounts

10 Derivatives continued

Hedge ineffectiveness recognised in other operating income comprised:

	2018 £m	2017 £m	2016 £m
Fair value hedging			
Gains/(losses) on the hedged items attributable to the hedged risk	54	(48)	1,146
(Losses)/gains on the hedging instruments	(7)	78	(1,117)
Fair value hedging ineffectiveness	47	30	29
Cash flow hedging ineffectiveness	(112)	9	(29)
Total	(65)	39	

The main sources of ineffectiveness for interest rate risk hedge accounting relationships are:

- The effect of the counterparty credit risk on the fair value of the interest rate swap, which is not reflected in the fair value of the hedged item attributable to the change in interest rate (fair value hedge).
- Differences in the repricing basis between the hedging instrument and hedged cash flows (cash flow hedge); and
- Upfront present values on the hedging derivatives where hedge accounting relationships have been designated after the trade date (cash flow hedge and fair value hedge).

Additional information on cash flow hedging and hedging of net assets can be found in the Statement of Changes in Equity.

11 Financial instruments classification

The following tables analyse financial assets and liabilities in accordance with the categories of financial instruments on an IFRS 9 basis at 31 December 2018 and on an IAS39 basis at 31 December 2017. Assets and liabilities outside the scope of IFRS 9/IAS 39 are shown within other assets and other liabilities.

Assets	MFVTPL (1) £m	DFV(2) £m	Hedging derivatives £m	FVOCI £m	Amortised cost £m	Other assets £m	Total £m
Cash and balances at central banks					88,897		88,897
Trading assets	75,119						75,119
Derivatives	131,098		2,251				133,349

Settlement balances						2,928		2,928
Loans to banks - amortised cost (3)						12,947		12,947
Loans to customers - amortised cost						305,089		305,089
Other financial assets		1,638			46,077	11,770		59,485
Intangible assets							6,616	6,616
Other assets							9,805	9,805
31 December 2018		207,855		2,251	46,077	421,631	16,421	694,235

	Held-for-trading £m	DFV(2) £m	Hedging derivatives £m	Available-for-sale £m	Loans and receivables £m	Held-to-maturity £m	Other assets £m	Total £m
Cash and balances at central banks					98,337			98,337
Trading assets	85,991							85,991
Derivatives	157,876		2,967					160,843
Settlement balances					2,517			2,517
Loans to banks - amortised cost (3)					11,517			11,517
Loans to customers - amortised cost					310,116			310,116
Other financial assets		190		43,968	3,643	4,128		51,929
Intangible assets							6,543	6,543
Other assets							10,263	10,263
31 December 2017	243,867	190	2,967	43,968	426,130	4,128	16,806	738,056

Notes:

(1) Mandatory fair value through profit or loss.

(2) Designated as at fair value through profit or loss.

(3) Includes items in the course of collection from other banks of £484 million (2017 - £1,017 million).

Notes on the consolidated accounts

11 Financial instruments - classification continued

Liabilities	Held-for-trading £m	DFV (1) £m	Hedging derivatives £m	Amortised cost £m	Other liabilities £m	£m
Bank deposits (2)				23,297		23,297
Customer deposits (3)				360,914		360,914
Settlement balances				3,066		3,066
Trading liabilities	72,350					72,350
Derivatives	125,954		2,943			128,897
Other financial liabilities		2,840		36,892		39,732
Subordinated liabilities		867		9,668		10,535
Other liabilities				2,218	6,736	8,954
31 December 2018	198,304	3,707	2,943	436,055	6,736	647,745
Bank deposits (2)				30,396		30,396
Customer deposits (3)				361,316		361,316
Settlement balances				2,844		2,844
Trading liabilities	81,982					81,982
Derivatives	150,935		3,571			154,506
Other financial liabilities		4,277		26,049		30,326
Subordinated liabilities		939		11,783		12,722
Other liabilities				2,181	12,690	14,871
31 December 2017	232,917	5,216	3,571	434,569	12,690	688,963

Notes:

(1) Designated as at fair value through profit or loss.

(2) Includes items in the course of transmission to other banks of £125 million (2017 - £214 million).

(3) The carrying amount of other customer accounts designated as at fair value through profit or loss is £26 million (2017 - £114 million) higher than the principal amount.

The Group s financial assets and liabilities include:	2018 £m	2017 £m
Reverse repos		
Loans to banks - amortised cost	3,539	2,152
Loans to customers - amortised cost	9	2,308
Trading assets	24,759	36,272
Repos		

Bank deposits		941	3,839
Customer deposits		3,774	6,669
Trading liabilities		25,645	28,363

	2018	2017	2016
Amounts included in operating profit/(loss) before tax:	£m	£m	£m
(Losses)/Gains on financial assets/liabilities designated as at fair value through profit or loss	(26)	60	(13)

The tables below present information on financial assets and financial liabilities that are offset on the balance sheet under IFRS or subject to enforceable master netting agreements together with financial collateral received or given.

	Instruments which can be offset			Potential for offset not recognised by IFRS					
	Gross	IFRS offset	Balance sheet	Effect of master netting and similar agreements	Cash collateral	Other financial collateral	Net amount after the effect of netting arrangements and related collateral	Instruments outside netting arrangements	Balance sheet total
2018	£m	£m	£m	£m	£m	£m	£m	£m	£m
Derivative assets	136,329	(5,041)	131,288	(106,762)	(17,937)	(4,469)	2,120	2,061	133,349
Derivative liabilities	133,965	(6,776)	127,189	(106,762)	(15,227)	(3,466)	1,734	1,708	128,897
Net position (1)	2,364	1,735	4,099		(2,710)	(1,003)	386	353	4,452
Trading reverse repos	53,148	(31,376)	21,772	(762)		(21,000)	10	2,987	24,759
Trading repos	55,864	(31,376)	24,488	(762)		(23,726)		1,157	25,645
Net position	(2,716)		(2,716)			2,726	10	1,830	(886)
2017									
Derivative assets	175,670	(17,088)	158,582	(128,287)	(20,311)	(5,850)	4,134	2,261	160,843
Derivative liabilities	170,405	(17,557)	152,848	(128,287)	(18,035)	(3,952)	2,574	1,658	154,506
Net position (1)	5,265	469	5,734		(2,276)	(1,898)	1,560	603	6,337
Trading reverse repos	65,508	(32,639)	32,869	(329)		(32,498)	42	3,403	36,272
Trading repos	58,695	(32,639)	26,056	(329)		(25,727)		2,307	28,363
Net position	6,813		6,813			(6,771)	42	1,096	7,909

Note:

(1) The net IFRS offset balance of £1,735 million (2017 - £469 million) relates to variation margin netting reflected on other balance sheet lines.

Notes on the consolidated accounts

12 Financial instruments - valuation

Critical accounting policy: Fair value - financial instruments

In accordance with Accounting policies 13 and 21, financial instruments classified as mandatory fair value through profit or loss, held-for-trading or designated as at fair value through profit or loss and financial assets classified as fair value through other comprehensive income are recognised in the financial statements at fair value. All derivatives are measured at fair value.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement takes into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. It also uses the assumptions that market participants would use when pricing the asset or liability. In determining fair value the Group maximises the use of relevant observable inputs and minimises the use of unobservable inputs.

Modelled approaches may be used to measure instruments classed as Level 2 or 3. Estimation expertise is required in the selection, implementation and calibration of appropriate models. The resulting modelled valuations are considered for accuracy and reliability. Portfolio level adjustments consistent with IFRS 13 are raised to incorporate counterparty credit risk, funding and margining risks. Expert judgement is used in the initial measurement of modelled products by control teams.

Where the Group manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, it measures the fair value of a group of financial assets and financial liabilities on the basis of the price that it would receive to sell a net long position (i.e. an asset) for a particular risk exposure or to transfer a net short position (i.e. a liability) for a particular risk exposure in an orderly transaction at the measurement date under current market conditions. Credit valuation adjustments are made when valuing derivative financial assets to incorporate counterparty credit risk. Adjustments are also made when valuing financial liabilities measured at fair value to reflect the Group s own credit standing.

Where the market for a financial instrument is not active, fair value is established using a valuation technique. These valuation techniques involve a degree of estimation, the extent of which depends on the instrument s complexity and the availability of market-based data. Further details about the valuation methodologies and the sensitivity to reasonably possible alternative assumptions of the fair value of financial instruments valued using techniques where at least one significant input is unobservable are given below.

	2018			2017		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
	£m	£m	£m	£m	£m	£m
Assets						
Trading assets						

Loans		44,983	120		58,331	150
Securities	22,003	7,312	701	19,648	7,009	853
Derivatives		131,513	1,836	10	159,109	1,724
Other financial assets						
Loans		768	136			56
Securities	40,132	6,172	507	37,147	6,450	505
Total financial assets held at fair value	62,135	190,748	3,300	56,805	230,899	3,288
Liabilities						
Trading liabilities						
Deposits		47,243	377		52,109	239
Debt securities in issue		791	112		1,057	50
Short positions	18,941	4,886		23,715	4,796	16
Derivatives		127,709	1,188	2	152,886	1,618
Other financial liabilities						
Debt securities in issue		2,348	280		3,141	262
Other deposits		212			874	
Subordinated liabilities		867			939	
Total financial liabilities held at fair value	18,941	184,056	1,957	23,717	215,802	2,185

Notes:

(1) Transfers between levels are deemed to have occurred at the beginning of the quarter in which the instruments were transferred.

(2) For an analysis of debt securities, by issuer, measurement classification and analysis of asset backed securities, and derivatives, by type and contract, refer to Capital and Risk management Credit risk.

(3) The determination of an instrument s level cannot be made at a global product level as a single product type can be in more than one level. For example, a single name corporate credit default swap could be in level 2 or level 3 depending on whether the reference counterparty s obligations are liquid or illiquid.

Notes on the consolidated accounts

12 Financial instruments - valuation continued

Fair value hierarchy

Financial Instruments carried at fair value have been classified under the IFRS fair value hierarchy as follows.

Level 1 Instruments valued using unadjusted quoted prices in active and liquid markets, for identical financial instruments. Examples include government bonds, listed equity shares and certain exchange-traded derivatives.

Level 2 - instruments valued using valuation techniques that have observable inputs., Examples include most government agency securities, investment-grade corporate bonds, certain mortgage products, including CLOs, most bank loans, repos and reverse repos, less liquid listed equities, state and municipal obligations, most notes issued, and certain money market securities and loan commitments and most OTC derivatives.

Level 3 - instruments valued using a valuation technique where at least one input which could have a significant effect on the instrument s valuation, is not based on observable market data. Examples include cash instruments which trade infrequently, certain syndicated and commercial mortgage loans, certain emerging markets and derivatives with unobservable model inputs.

Valuation techniques

RBS derives fair value of its instruments differently depending on whether the instrument is a non-modelled or a modelled product.

Non-modelled products are valued directly from a price input typically on a position by position basis and include cash, equities and most debt securities.

Modelled products valued using a pricing model range in complexity from comparatively vanilla products such as interest rate swaps and options (e.g. interest rate caps and floors) through to more complex derivatives. The valuation of modelled products requires an appropriate model and inputs into this model. Sometimes models are also used to derive inputs (e.g. to construct volatility surfaces). RBS uses a number of modelling methodologies.

Inputs to valuation models

Values between and beyond available data points are obtained by interpolation and extrapolation. When utilising valuation techniques, the fair value can be significantly affected by the choice of valuation model and by underlying assumptions concerning factors such as the amounts and timing of cash flows, discount rates and credit risk. The principal inputs to these valuation techniques are as follows:

Bond prices - quoted prices are generally available for government bonds, certain corporate securities and some mortgage-related products.

Credit spreads - where available, these are derived from prices of credit default swaps or other credit based instruments, such as debt securities. For others, credit spreads are obtained from third-party benchmarking services. For counterparty credit spreads, adjustments are made to market prices (or parameters) when the creditworthiness of the counterparty differs from that of the assumed counterparty in the market price (or parameters).

Interest rates - these are principally benchmark interest rates such as the London Interbank Offered Rate (LIBOR), Overnight Index Swaps (OIS) rate and other quoted interest rates in the swap, bond and futures markets.

Foreign currency exchange rates - there are observable prices both for spot and forward contracts and futures in the world s major currencies.

Equity and equity index prices - quoted prices are generally readily available for equity shares listed on the world s major stock exchanges and for major indices on such shares.

Commodity prices - many commodities are actively traded in spot and forward contracts and futures on exchanges in London, New York and other commercial centres.

Price volatilities and correlations - volatility is a measure of the tendency of a price to change with time.

Correlation measures the degree which two or more prices or other variables are observed to move together.

Prepayment rates - the fair value of a financial instrument that can be prepaid by the issuer or borrower differs from that of an instrument that cannot be prepaid. In valuing prepayable instruments that are not quoted in active markets, RBS considers the value of the prepayment option.

Recovery rates/loss given default - these are used as an input to valuation models and reserves for asset-backed securities and other credit products as an indicator of severity of losses on default. Recovery rates are primarily sourced from market data providers or inferred from observable credit spreads.

Valuation control

RBS s control environment for the determination of the fair value of financial instruments includes formalised protocols for the review and validation of fair values independent of the businesses entering into the transactions.

Independent price verification (IPV) is a key element of the control environment. Valuations are first performed by the business which entered into the transaction. Such valuations may be directly from available prices, or may be derived using a model and variable model inputs. These valuations are reviewed, and if necessary amended, by a team independent of those trading the financial instruments, in the light of available pricing evidence.

Where measurement differences are identified through the IPV process these are grouped by fair value level and quality of data. If the size of the difference exceeds defined thresholds adjustment to independent levels are made.

IPV takes place at least each monthly, for all fair value positions. The IPV control includes formalised reporting and escalation of any valuation differences in breach of established thresholds.

The Modelled Product Review Committee sets the policy for model documentation, testing and review, and prioritises models with significant exposure being reviewed by the RBS Model Risk team. Valuation Committees are made up of valuation specialists and senior business representatives from various functions and oversees pricing, reserving and valuations issues. These committees meet monthly to review and ratify any methodology changes. The Executive Valuation Committee meets quarterly to address key material and subjective valuation issues, to review items escalated by Valuation Committees and to discuss other relevant matters of including prudential valuation.

Initial classification of a financial instrument is carried out by the Product Control team following the principles in IFRS 13. They base their judgment on information gathered during the IPV process for instruments which include the sourcing of independent prices and model inputs. The quality and completeness of the information gathered in the IPV process gives an indication as to the liquidity and valuation uncertainty of an instrument. These initial classifications are subject to senior management review. Particular attention is paid to instruments crossing from one level to another, new instrument classes or products, instruments that are generating significant profit and loss and instruments where valuation uncertainty is high.

RBS uses consensus prices for the IPV of some instruments. The consensus service encompasses the equity, interest rate, currency, commodity, credit, property, fund and bond markets, providing comprehensive matrices of vanilla prices and a wide selection of exotic products.

Notes on the consolidated accounts

12 Financial instruments - valuation continued

RBS contributes to consensus pricing services where there is a significant interest either from a positional point of view or to test models for future business use. Data sourced from consensus pricing services are used for a combination of control processes including direct price testing, evidence of observability and model testing. In practice this means that RBS submits prices for all material positions for which a service is available. Data from consensus services are subject to the same level of quality review as other inputs used for IPV process.

In order to determine a reliable fair value, where appropriate, management applies valuation adjustments to the pricing information gathered from the above sources. The sources of independent data are reviewed for quality and are applied in the IPV processes using a formalised input quality hierarchy. These adjustments reflect RBS s assessment of factors that market participants would consider in setting a price.

Where unobservable inputs are used, RBS may determine a range of possible valuations derived from differing stress scenarios to determine the sensitivity associated with the valuation. When establishing the fair value of a financial instrument using a valuation technique, RBS considers adjustments to the modelled price which market participants would make when pricing that instrument. Such adjustments include the credit quality of the counterparty and adjustments to compensate for model limitations.

When valuing financial instruments in the trading book, adjustments are made to mid-market valuations to cover bid-offer spread, funding and credit risk. These adjustments are presented in the table below:

	2018	2017
Adjustment	£m	£m
Funding FVA	250	440
Credit CVA	419	346
Bid Offer	238	285
Product and deal specific	327	1,033
	1,234	2,104

The reduction in valuation reserves was primarily driven by a combination of trade close-out activity and a reallocation of product and deal specific reserves that are now included within the discount rate applied to the derivative cash flows. There was a net increase in CVA due to the extension of the CVA reserve to include margin period of risk on collateralised counterparties and a reclassification of product and deal specific reserves to CVA.

Funding valuation adjustment (FVA)

FVA represents an estimate of the adjustment that a market participant would make to incorporate funding costs and benefits that arise in relation to derivative exposures. FVA is calculated as a portfolio level adjustment.

Funding levels are applied to estimated potential future exposures. For uncollateralised derivatives, the modelling of the exposure is consistent with the approach used in the calculation of CVA, and the counterparty contingent nature of the exposure is reflected in the calculation. For collateralised derivatives, the exposure reflects initial margin posting requirements.

Credit valuation adjustments (CVA)

CVA represents an estimate of the adjustment to fair value that a market participant would make to incorporate the counterparty credit risk inherent in derivative exposures. CVA is actively managed by a credit and market risk hedging process, and therefore movements in CVA are partially offset by trading revenue on the hedges.

The CVA is calculated on a portfolio basis reflecting an estimate of the amount a third party would charge to assume the credit risk.

Collateral held under a credit support agreement is factored into the CVA calculation. In such cases where RBS holds collateral against counterparty exposures, CVA is held to the extent that residual risk remains.

Bid-offer

Fair value positions are adjusted to bid (long positions) or offer (short positions) levels, by marking individual cash positions directly to bid or offer or by taking bid-offer reserves calculated on a portfolio basis for derivatives exposures. The bid-offer approach is based on current market spreads and standard market bucketing of risk.

Bid-offer spreads vary by maturity and risk type to reflect different spreads in the market. For positions where there is no observable quote, the bid-offer spreads are widened in comparison to proxies to reflect reduced liquidity or observability. Bid-offer methodologies may also incorporate liquidity triggers whereby wider spreads are applied to risks above pre-defined thresholds.

As permitted by IFRS 13, netting is applied on a portfolio basis to reflect the value at which RBS believes it could exit the portfolio, rather than the sum of exit costs for each of the portfolio s individual trades. This is applied where the asset and liability positions are managed as a portfolio for risk and reporting purposes.

The discount rates applied to derivative cash flows in determining fair value reflect any underlying collateral agreements. Collateralised derivatives are generally discounted at the relevant OIS-related rates at an individual trade level. Reserves are held to the extent that the discount rates applied do not reflect all of the terms of the collateral agreements.

Product and deal specific

On initial recognition of financial assets and liabilities valued using valuation techniques incorporating information other than observable market data, any difference between the transaction price and that derived from the valuation technique is deferred. Such amounts are recognised in profit or loss over the life of the transaction; when market data becomes observable; or when the transaction matures or is closed out as appropriate. At 31 December 2018, net gains of £59 million (2017 - £56 million) were carried forward. During the year, net gains of £151 million (2017 - £64 million) were deferred and £148 million (2017 - £80 million) were recognised in the income statement.

Where system generated valuations do not accurately recover market prices, manuals valuation adjustments are applied either at a position or portfolio level. Manual adjustments are subject to the scrutiny of independent control teams and are subject to monthly review by senior management.

Notes on the consolidated accounts

12 Financial instruments valuation: Level 3 ranges of unobservable inputs

				2018		2017	
Financial instrument	Valuation Technique	Unobservable inputs	Units	Low	High	Low	High
Trading assets and Other financial assets							
Loans	Price-based	Price	%	0	132	0	101
Debt securities	Price-based	Price	GBP	0	154	0	370
Equity Shares	Price-based	Price	GBP	0	24,181	0	585,066
	Valuation	Discount factor	%	8	11	9	13
	Valuation	Fund NAV	%	80	120	80	120
Trading liabilities and Other financial liabilities							
Customer accounts	DCF based on recoveries	Correlation	%	(45)	99	(29)	86
		Interest rate	%	(0.36)	1.74	(0.38)	2.61
Debt securities in issue	Price-based	Price	CCY	21 JPY	136 EUR	56 JPY	149 EUR
	Valuation	Fund NAV	GBP	0	622	0	977
Derivative assets and liabilities							
Credit derivatives	DCF based on recoveries	Credit spreads	bps	18	500	0	500
	Option pricing	Correlation	%	(50)	80	(50)	80
		Volatility	%	47	80	38	80
		Upfront points	%	0	100	0	99
		Recovery rate	%	10	40	10	40
	Price-based	Price	%	90	110		
Interest rate & FX derivatives	Option pricing	Correlation	%	(45)	99	(75)	100
		Volatility	%	1	76	0	292
Equity derivatives	Option pricing	Correlation	%	(57)	92	(57)	95
		Forward	Points	864	7,106	146	189
		Volatility	%	1	49	7	11

Notes:

(1) The table above presents the range of values for significant inputs used in the valuation of level 3 assets and liabilities. The range represents the highest and lowest values of the input parameters and therefore is not a measure of parameter uncertainty. Movements in the underlying input may have a favourable or unfavourable impact on the valuation depending on the particular terms of the contract and the exposure. For example, an increase in the credit spread of a bond would be favourable for the issuer but unfavourable for the note holder. Whilst RBS indicates where it considers that there are significant relationships between the inputs, their inter-relationships will be affected by macro economic factors including interest rates, foreign exchange rates or equity index levels.

(2) Credit spreads and discount margins: credit spreads and margins express the return required over a benchmark rate or index to compensate for the credit risk associated with a cash instrument. A higher credit spread would indicate that the underlying instrument has more credit risk associated with it. Consequently, investors require a higher yield to compensate for the higher risk.

(3) Price and yield: There may be a range of prices used to value an instrument that may be a direct comparison of one instrument or portfolio with another or, movements in a more liquid instrument may be used to indicate the movement in the value of a less liquid instrument. The comparison may also be indirect in that adjustments are made to the price to reflect differences between the pricing source and the instrument

being valued.

(4) Recovery rate: reflects market expectations about the return of principal for a debt instrument or other obligations after a credit event or on liquidation. Recovery rates tend to move conversely to credit spreads.

(5) Valuation: for private equity investments, values may be estimated by looking at past prices of similar stocks and from valuation statements where valuations are usually derived from earnings measures such as EBITDA or net asset value (NAV). Similarly for equity or bond fund investments, prices may be estimated from valuation or credit statements using NAV or similar measures.

(6) Correlation: measures the degree by which two prices or other variables are observed to move together. If they move in the same direction there is positive correlation; if they move in opposite directions there is negative correlation. Correlations typically include relationships between: default probabilities of assets in a basket (a group of separate assets), exchange rates, interest rates and other financial variables.

(7) Volatility: a measure of the tendency of a price to change with time.

(8) Interest rate delta: these ranges represent the low/high marks on the relevant discounting curve.

(9) Upfront points: where CDS contracts are standardised, the inherent spread of the trade may exceed the standard premium paid or received under the contract. Upfront points will compensate for the difference between the standard premium and the actual premium at the start of the contract.

(10) RBS does not have any material liabilities measured at fair value that are issued with an inseparable third party credit enhancement.

Notes on the consolidated accounts

12 Financial instruments valuation: areas of judgment

Whilst the business has simplified, the diverse range of products historically traded by RBS results in a wide range of instruments that are classified into Level 3 of the hierarchy. Whilst the majority of these instruments naturally fall into a particular level, for some products an element of judgment is required. The majority of RBS financial instruments carried at fair value are classified as Level 2. IFRS requires extra disclosures in respect of level 3 instruments.

Active and inactive markets

A key input in the decision making process for the allocation of assets to a particular level is market activity. In general, the degree of valuation uncertainty depends on the degree of liquidity of an input.

Where markets are liquid, little judgment is required. However, when the information regarding the liquidity in a particular market is not clear, a judgment may need to be made. This can be more difficult as assessing the liquidity of a market is not always straightforward. For an equity traded on an exchange, daily volumes of trading can be seen, but for an over-the-counter (OTC) derivative assessing the liquidity of the market with no central exchange is more difficult.

A key related matter is where a market moves from liquid to illiquid or vice versa. Where this change is considered to be temporary, the classification is not changed. For example, if there is little market trading in a product on a reporting date but at the previous reporting date and during the intervening period the market has been considered to be liquid, the instrument will continue to be classified in the same level in the hierarchy. This is to provide consistency so that transfers between levels are driven by genuine changes in market liquidity and do not reflect short term or seasonal effects. Material movements between levels are reviewed quarterly.

The breadth and depth of the IPV data allows for a rules based quality assessment to be made of market activity, liquidity and pricing uncertainty, which assists with the process of allocation to an appropriate level. Where suitable independent pricing information is not readily available, the quality assessment will result in the instrument being assessed as Level 3.

Modelled products

For modelled products the market convention is to quote these trades through the model inputs or parameters as opposed to a cash price equivalent. A mark-to-market is derived from the use of the independent market inputs calculated using RBS s model.

The decision to classify a modelled instrument as Level 2 or 3 will be dependent upon the product/model combination, the currency, the maturity, the observability and quality of input parameters and other factors. All these must be assessed to classify the asset. If an input fails the observability or quality tests then the instrument is considered to be in Level 3 unless the input can be shown to have an insignificant effect on the overall valuation of the product.

The majority of derivative instruments for example vanilla interest rate swaps, foreign exchange swaps and liquid single name credit derivatives are classified as Level 2 as they are vanilla products valued using observable inputs. The valuation uncertainty on these is considered to be low and both input and output testing may be available.

Non-modelled products

Non-modelled products are generally quoted on a price basis and can therefore be considered for each of the three levels. This is determined by the market activity, liquidity and valuation uncertainty of the instruments which is in turn measured from the availability of independent data used by the IPV process to allocate positions to IPV quality levels.

The availability and quality of independent pricing information are considered during the classification process. An assessment is made regarding the quality of the independent information. For example, where consensus prices are used for non-modelled products, a key assessment of the quality of a price is the depth of the number of prices used to provide the consensus price. If the depth of contributors falls below a set hurdle rate, the instrument is considered to be Level 3. This hurdle rate is that used in the IPV process to determine the IPV quality rating. However, where an instrument is generally considered to be illiquid, but regular quotes from market participants exist, these instruments may be classified as Level 2 depending on frequency of quotes, other available pricing and whether the quotes are used as part of the IPV process or not.

For some instruments with a wide number of available price sources, there may be differing quality of available information and there may be a wide range of prices from different sources. In these situations the highest quality source is used to determine the classification of the asset. For example, a tradable quote would be considered a better source than a consensus price.

	2018			2017		
	Level 3	Favourable	Unfavourable	Level 3	Favourable	Unfavourable
	£m	£m	£m	£m	£m	£m
Assets						
Trading assets						
Loans	120	10	(10)	150		
Securities	701	20	(10)	853	30	(10)
Derivatives						
Interest rate	1,487	120	(120)	1,340	140	(140)
Foreign exchange	130	10	(10)	148	10	(10)
Other	219	10	(20)	236	10	(20)
Other financial assets						
Loans	136	10	(20)	56		
Securities	507	50	(30)	505	20	(30)
	3,300	230	(220)	3,288	210	(210)
Liabilities						
Trading liabilities						
Deposits	377	40	(40)	239	20	(20)
Debt securities in issue	112	10	(10)	50		
Short positions				16		
Derivatives						
Interest rate	808	70	(70)	1,104	120	(120)
Foreign exchange	279	10	(10)	358	10	(10)
Other	101		(10)	156	10	(10)
Other financial liabilities						
Debt securities in issue	280	10	(10)	262	10	(10)
	1,957	140	(150)	2,185	170	(170)

Notes on the consolidated accounts

12 Financial instruments valuation: level 3 sensitivities

The Level 3 sensitivities presented above are calculated at a trade or low level portfolio basis. They are not calculated on an overall portfolio basis and therefore do not reflect the likely potential uncertainty on the portfolio as a whole. The figures are aggregated and do not reflect the correlated nature of some of the sensitivities. In particular, for some of the portfolios the sensitivities may be negatively correlated where a downwards movement in one asset would produce an upwards movement in another, but due to the additive presentation of the above figures this correlation cannot be displayed. The actual potential downside sensitivity of the total portfolio may be less than the non-correlated sum of the additive figures as shown in the above table.

Reasonably plausible alternative assumptions of unobservable inputs are determined based on a specified target level of certainty of 90%. The assessments recognise different favourable and unfavourable valuation movements where appropriate. Each unobservable input within a product is considered separately and sensitivity is reported on an additive basis.

Alternative assumptions are determined with reference to all available evidence including consideration of the following: quality of independent pricing information taking into account consistency between different sources, variation over time, perceived tradability or otherwise of available quotes; consensus service dispersion ranges; volume of trading activity and market bias (e.g. one-way inventory); day 1 profit or loss arising on new trades; number and nature of market participants; market conditions; modelling consistency in the market; size and nature of risk; length of holding of position; and market intelligence.

Other considerations

Whilst certain inputs used to calculate CVA, FVA and own credit adjustments are not based on observable market data, the uncertainty of the inputs is not considered to have a significant effect on the net valuation of the related derivative portfolios and issued debt. The classification of the derivative portfolios and issued debt is not determined by the observability of these inputs and any related sensitivity does not form part of the Level 3 sensitivities presented.

Level 3

The following table shows the movement in level 3 assets and liabilities in the year.

	2018				2017			
	Trading assets (3)	Other financial assets (4)	Total assets	Total liabilities	Trading assets (3)	Other financial assets (4)	Total assets	Total liabilities
	£m	£m	£m	£m	£m	£m	£m	£m

At 1 January (1)	2,692	530	3,222	2,187	3,933	604	4,537	2,997
Amounts recorded in the income statement (2)	(147)	178	31	(344)	(593)	21	(572)	(341)
Amounts recorded in the statement of comprehensive income		23	23			2	2	
Level 3 transfers in	1,307	19	1,326	419	679	315	994	530
Level 3 transfers out	(624)	(1)	(625)	(231)	(1,015)	(3)	(1,018)	(672)
Issuances				47	371		371	
Purchases	871	16	887	401	1,788	20	1,808	412
Settlements	(512)	(3)	(515)	(204)	(161)		(161)	(423)
Sales	(930)	(125)	(1,055)	(316)	(2,286)	(369)	(2,655)	(323)
Foreign exchange and other adjustments		6	6	(2)	11	(29)	(18)	5
At 31 December	2,657	643	3,300	1,957	2,727	561	3,288	2,185
Amounts recorded in the income statement in respect of balances held at year end								
- unrealised	(134)	158	24	(330)	(59)	(21)	(80)	595
- realised	(2)	6	4		271	5	276	(100)

Notes:

(1) Refer to Note 33 for further information on the impact of IFRS9 on classification and basis of preparation, year ended 31 December 2018 prepared under IFRS9 and prior years under IAS39.

(2) There were £185 million net losses on trading assets and liabilities (2017 - £240 million HFT) recorded in income from trading activities. Net losses on other instruments of £190 million (2017 - £9 million gains) were recorded in other operating income and interest income as appropriate.

(3) Trading assets comprise assets held at fair value in trading portfolios.

(4) Other financial assets comprise fair value through other comprehensive income (2017 - available-for-sale), designated at fair value through profit or loss and other fair value through profit or loss.

Notes on the consolidated accounts

12 Financial instruments: fair value of financial instruments not carried at fair value

The following table shows the carrying value and fair value of financial instruments carried at amortised cost on the balance sheet.

2018	Items where fair value approximates carrying value £bn	Carrying value £bn	Fair value £bn	Fair value hierarchy level Level 1 £bn	Level 2 £bn	Level 3 £bn
Financial assets						
Cash and balances at central banks	88.9					
Settlement balances	2.9					
Loans to banks	0.5	12.4	12.4		9.2	3.2
Loans to customers		305.1	301.7		0.5	301.2
Other financial assets						
Securities		11.8	11.8	7.3	3.0	1.5
Financial liabilities						
Bank deposits	4.2	19.1	18.5		13.9	4.6
Customer deposits	307.1	53.8	54.6		10.4	44.2
Settlement balances	3.1					
Other financial liabilities						
Debt securities in issue		36.9	38.6		36.9	1.7
Subordinated liabilities		9.7	10.0		9.9	0.1
Other liabilities - notes in circulation	2.2					
2017						
Financial assets						
Cash and balances at central banks	98.3					
Settlement balances	2.5					
Loans to banks	1.0	10.5	10.5		9.1	1.4
Loans to customers		310.1	306.8		1.3	305.5
Other financial assets						
Securities		7.8	7.9	4.3	1.5	2.1
Financial liabilities						
Bank deposits	4.5	25.9	26.0		22.4	3.6
Customer deposits	321.5	39.8	39.9		12.9	27.0
Settlement balances	2.8					
Other financial liabilities						
Debt securities in issue		26.0	27.3		22.2	5.1
Subordinated liabilities		11.8	12.6		12.5	0.1
Other liabilities - notes in circulation	2.2					

Notes on the consolidated accounts

12 Financial instruments: fair value of financial instruments not carried at fair value continued

The fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Quoted market values are used where available; otherwise, fair values have been estimated based on discounted expected future cash flows and other valuation techniques. These techniques involve uncertainties and require assumptions and judgments covering prepayments, credit risk and discount rates. Furthermore there is a wide range of potential valuation techniques. Changes in these assumptions would significantly affect estimated fair values. The fair values reported would not necessarily be realised in an immediate sale or settlement.

The assumptions and methodologies underlying the calculation of fair values of financial instruments at the balance sheet date are as follows:

Short-term financial instruments

For certain short-term financial instruments: cash and balances at central banks, items in the course of collection from other banks, settlement balances, items in the course of transmission to other banks, customer demand deposits and notes in circulation, carrying value is a reasonable approximation of fair value.

Loans to banks and customers

In estimating the fair value of net loans to customers and banks measured at amortised cost, RBS s loans are segregated into appropriate portfolios reflecting the characteristics of the constituent loans. Two principal methods are used to estimate fair value:

(a) Contractual cash flows are discounted using a market discount rate that incorporates the current spread for the borrower or where this is not observable, the spread for borrowers of a similar credit standing. This method is used for portfolios where counterparties have external ratings: institutional and corporate lending in NatWest Markets.

(b) Expected cash flows (unadjusted for credit losses) are discounted at the current offer rate for the same or similar products. This approach is adopted for lending portfolios in UK PB, Ulster Bank RoI, Commercial Banking (SME loans) and Private Banking in order to reflect the homogeneous nature of these portfolios.

For certain portfolios where there are very few or no recent transactions, a bespoke approach is used.

Debt securities

The majority of debt securities are valued using quoted prices in active markets, or using quoted prices for similar assets in active markets. Fair values of the rest are determined using discounted cash flow valuation techniques.

Deposits by banks and customer accounts

Fair values of deposits are estimated using discounted cash flow valuation techniques.

Debt securities in issue and subordinated liabilities

Fair values are determined using quoted prices for similar liabilities where available or by reference to valuation techniques, adjusting for own credit spreads where appropriate.

13 Financial instruments - maturity analysis

Remaining maturity

The following table shows the residual maturity of financial instruments, based on contractual date of maturity.

	2018			2017		
	Less than 12 months £m	More than 12 months £m	Total £m	Less than 12 months £m	More than 12 months £m	Total £m
Assets						
Cash and balances at central banks	88,897		88,897	98,337		98,337
Trading assets	49,094	26,025	75,119	66,315	19,676	85,991
Derivatives	28,503	104,846	133,349	32,372	128,471	160,843
Settlement balances	2,928		2,928	2,517		2,517
Loans to banks - amortised cost	12,833	114	12,947	11,424	93	11,517
Loans to customers - amortised cost	67,354	237,735	305,089	69,832	240,284	310,116
Other financial assets	11,681	47,804	59,485	8,776	43,153	51,929
Liabilities						
Bank deposits	7,438	15,859	23,297	10,813	19,583	30,396
Customer deposits	359,148	1,766	360,914	358,857	2,459	361,316
Settlement balances	3,066		3,066	2,844		2,844
Trading liabilities	50,668	21,682	72,350	53,787	28,195	81,982
Derivatives	29,028	99,869	128,897	32,212	122,294	154,506
Other financial liabilities	8,240	31,492	39,732	8,467	21,859	30,326
Subordinated liabilities	299	10,236	10,535	2,383	10,339	12,722

Notes on the consolidated accounts

13 Financial instruments maturity analysis continued

Assets and liabilities by contractual cash flow maturity

The tables below show the contractual undiscounted cash flows receivable and payable, up to a period of 20 years, including future receipts and payments of interest of financial assets and liabilities by contractual maturity. The balances in the following tables do not agree directly with the consolidated balance sheet, as the tables include all cash flows relating to principal and future coupon payments, presented on an undiscounted basis. The tables have been prepared on the following basis:

Financial assets have been reflected in the time band of the latest date on which they could be repaid, unless earlier repayment can be demanded by RBS. Financial liabilities are included at the earliest date on which the counterparty can require repayment, regardless of whether or not such early repayment results in a penalty. If the repayment of a financial instrument is triggered by, or is subject to, specific criteria such as market price hurdles being reached, the asset is included in the time band that contains the latest date on which it can be repaid, regardless of early repayment.

The liability is included in the time band that contains the earliest possible date on which the conditions could be fulfilled, without considering the probability of the conditions being met.

For example, if a structured note is automatically prepaid when an equity index exceeds a certain level, the cash outflow will be included in the less than three months period, whatever the level of the index at the year end. The settlement date of debt securities in issue, issued by certain securitisation vehicles consolidated by RBS, depends on when cash flows are received from the securitised assets. Where these assets are prepayable, the timing of the cash outflow relating to securities assumes that each asset will be prepaid at the earliest possible date. As the repayments of assets and liabilities are linked, the repayment of assets in securitisations is shown on the earliest date that the asset can be prepaid, as this is the basis used for liabilities.

The principal amounts of financial assets and liabilities that are repayable after 20 years or where the counterparty has no right to repayment of the principal are excluded from the table, as are interest payments after 20 years.

MFVTPL assets of £207.9 billion (2017 - £243.9 billion) and HFT liabilities of £198.3 billion (2017 - £232.9 billion) have been excluded from the following tables.

	0-3 months	3-12 months	1-3 years	3-5 years	5-10 years	10-20 years
2018	£m	£m	£m	£m	£m	£m
Assets by contractual maturity						
Cash and balances at central banks	88,897					
Settlement balances	2,928					

Loans to banks - amortised cost	11,920	925	106			
Other financial assets (1)	4,451	7,397	14,138	11,279	11,826	2,744
Total maturing assets	108,196	8,322	14,244	11,279	11,826	2,744
Loans to customers - amortised cost	43,096	32,087	66,441	51,839	66,978	79,543
Derivatives held for hedging	224	529	995	345	152	130
	151,516	40,938	81,680	63,463	78,956	82,417
Liabilities by contractual maturity						
Bank deposits	7,417	21	13,785	2,003		59
Settlement balance	3,066					
Other financial liabilities	1,736	7,226	10,724	11,658	9,316	2,029
Subordinated liabilities	131	637	1,476	7,532	1,737	1,422
Other liabilities (2)	2,152					
Total maturing liabilities	14,502	7,884	25,985	21,193	11,053	3,510
Customer deposits	351,054	8,114	1,727	14	6	26
Derivatives held for hedging	181	306	1,062	416	637	531
	365,737	16,304	28,774	21,623	11,696	4,067
Guarantees and commitments notional amount						
Guarantees (3)	3,952					
Commitments (4)	116,843					
	120,795					

For notes to the above table refer to the following page.

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13 Financial instruments maturity analysis continued

2017	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
Assets by contractual maturity						
Cash and balances at central banks	98,337					
Settlement balances	2,517					
Loans to banks - amortised cost	10,792	633	94			
Other financial assets (1)	3,675	5,889	11,960	11,312	12,813	3,638
Total maturing assets	115,321	6,522	12,054	11,312	12,813	3,638
Loans to customers - amortised cost	45,898	32,031	65,077	52,016	68,500	81,995
Derivatives held for hedging	281	832	1,336	334	166	111
	161,500	39,385	78,467	63,662	81,479	85,744
Liabilities by contractual maturity						
Bank deposits	9,180	1,740	3,614	16,023	61	71
Settlement balances	2,844					
Other financial liabilities	4,360	4,777	10,640	3,731	9,762	49
Subordinated liabilities	87	2,645	1,515	1,620	7,746	2,582
Other liabilities (2)	2,186					
Total maturing liabilities	18,657	9,162	15,769	21,374	17,569	2,702
Customer deposits	356,340	3,843	1,052	77	20	28
Derivatives held for hedging	212	289	1,188	526	813	738
	375,209	13,294	18,009	21,977	18,402	3,468
Guarantees and commitments notional amount						
Guarantees (3)	7,718					
Commitments (4)	121,229					
	128,947					

Notes:

(1) Other financial assets excludes equity shares.

(2) Other liabilities include notes in circulation.

(3) RBS is only called upon to satisfy a guarantee when the guaranteed party fails to meet its obligations. RBS expects most guarantees it provides to expire unused.

(4) RBS has given commitments to provide funds to customers under undrawn formal facilities, credit lines and other commitments to lend subject to certain conditions being met by the counterparty. RBS does not expect all facilities to be drawn, and some may lapse before drawdown.

Notes on the consolidated accounts

14 Loan impairment provisions

Loan exposure and impairment metrics

The table below summarises loans and related credit impairment measures on an IFRS 9 basis at 31 December 2018 and 1 January 2018 and on an IAS 39 basis at 31 December 2017.

	31 December 2018 (1) £m	1 January 2018 (1) £m	31 December 2017 £m
Loans - amortised cost			
Stage 1	285,985	333,929	
Stage 2	26,097	26,972	
Stage 3	7,718	11,283	
	319,800	372,184	321,633
ECL provisions (2)			
- Stage 1	285	261	
- Stage 2	763	621	
- Stage 3	2,320	3,565	
	3,368	4,447	3,814
ECL provision coverage (3)			
- Stage 1 %	0.10	0.1	
- Stage 2 %	2.92	2.3	
- Stage 3 %	30.06	31.6	
	1.05	1.2	1.20
Impairment losses			
ECL charge (4)	398		530
ECL loss rate - annualised (basis points)	12.45		16.48
Amounts written off	1,494		1,210

Notes:

(1) The analysis tables as at 31 December 2018 include all loans within IFRS 9 ECL scope and exclude debt securities. The comparative table at 1 January 2018 includes loans and debt securities of £50.4 billion, of which £42.7 billion related to debt securities classified as FVOCI. ECL on these debt securities at 1 January 2018 was £28 million, of which £4 million related to those classified as FVOCI.

(2) ECL provisions in the above table are provisions on loan assets only. Other ECL provisions not included, relate to cash, debt securities and contingent liabilities and amount to £28 million, of which £5 million was FVOCI.

(3) ECL provisions coverage is ECL provisions divided by loans - amortised cost.

(4) ECL charge balances in the above table included a £3 million charge relating to other financial assets, of which a £1 million charge related to assets at FVOCI; and a £31 million release related to contingent liabilities.

Notes on the consolidated accounts

14 Loan impairment provisions continued

Critical accounting policy: Loan impairment provisions

The Group s 2017 loan impairment provisions were established in accordance with IAS 39 in respect of incurred losses. They comprised individual and collective components as more fully explained in the 2017 Annual Report on Form 20-F. In 2018 the loan impairment provisions have been established in accordance with IFRS 9. Accounting policy 14 sets out how the expected loss approach is applied. At 31 December 2018, customer loan impairment provisions amounted to £3,368 million (2017 - £3,814 million). A loan is impaired when there is objective evidence that the cash flows will not occur in the manner expected when the loan was advanced. Such evidence includes changes in the credit rating of a borrower, the failure to make payments in accordance with the loan agreement; significant reduction in the value of any security; breach of limits or covenants; and observable data about relevant macroeconomic measures.

The impairment loss is the difference between the carrying value of the loan and the present value of estimated future cash flows at the loan s original effective interest rate.

The measurement of credit impairment under the IFRS expected loss model depends on management s assessment of any potential deterioration in the creditworthiness of the borrower, its modelling of expected performance and the application of economic forecasts. All three elements require judgments that are potentially significant to the estimate of impairment losses. Further information and sensitivity analyses are on Page 119.

IFRS 9 ECL model design principles

To meet IFRS 9 requirements for ECL estimation, PD, LGD and EAD used in the calculations must be:

- Unbiased - material regulatory conservatism has been removed to produce unbiased model estimates;
- Point-in-time - recognise current economic conditions;
- Forward-looking - incorporated into PD estimates and, where appropriate, EAD and LGD estimates; and
- For the life of the loan - all models produce a term structure to allow a lifetime calculation for assets in Stage 2 and Stage 3.

IFRS 9 requires that at each reporting date, an entity shall assess whether the credit risk on an account has increased significantly since initial recognition. Part of this assessment requires a comparison to be made between the current lifetime PD (i.e. the current probability of default over the remaining lifetime) with the equivalent lifetime PD as determined at the date of initial recognition.

The general approach for the IFRS 9 LGD models has been to leverage the Basel LGD models with bespoke IFRS 9 adjustments to ensure unbiased estimates, i.e. use of effective interest rate as the discount rate and the removal of: downturn calibration, indirect costs, other conservatism and regulatory floors.

For Wholesale, while conversion ratios in the historical data show temporal variations, these cannot (unlike in the case of PD and some LGD models) be sufficiently explained by the CCI measure and are presumed to be driven to a larger extent by exposure management practices. Therefore point-in-time best estimates measures for EAD are derived by estimating the regulatory model specification on a rolling five year window.

Approach for multiple economic scenarios (MES)

The base scenario plays a greater part in the calculation of ECL than the approach to MES.

15 Other financial assets

	Debt securities							
	Central and local government			Other		Equity	Other	
	UK	US	Other	debt	Total	shares	loans	Total
2018	£m	£m	£m	£m	£m	£m	£m	£m
Mandatory fair value through profit or loss				669	669	65	904	1,638
Fair value through other comprehensive income	17,192	11,767	11,329	5,306	45,594	483		46,077
Amortised cost	6,928	264	120	4,458	11,770			11,770
Total	24,120	12,031	11,449	10,433	58,033	548	904	59,485
2017								
Designated as at fair value through profit or loss						134	56	190
Available-for-sale	17,656	8,461	11,454	6,110	43,681	287		43,968
Loans and receivables				3,643	3,643			3,643
Held-to-maturity	4,128				4,128			4,128
Total	21,784	8,461	11,454	9,753	51,452	421	56	51,929

Equity shares classified as fair value through other comprehensive income include the following entities and 2018 dividend income received; VISA Inc. £98 million (dividend of £1 million) and Tradeweb Markets LLC £89 million (dividend of £4 million).

Notes on the consolidated accounts

16 Intangible assets

	2018			2017		
	Goodwill	Other (1)	Total	Goodwill	Other (1)	Total
Cost	£m	£m	£m	£m	£m	£m
At 1 January	18,039	2,259	20,298	17,756	2,095	19,851
Currency translation and other adjustments	77	9	86	283	(3)	280
Acquisition of subsidiaries	48	2	50			
Additions		364	364		384	384
Disposals and write-off of fully amortised assets		(610)	(610)		(217)	(217)
At 31 December	18,164	2,024	20,188	18,039	2,259	20,298
Accumulated amortisation and impairment						
At 1 January	12,481	1,274	13,755	12,198	1,173	13,371
Currency translation and other adjustments	77	5	82	283	(5)	278
Disposals and write-off of fully amortised assets		(573)	(573)		(145)	(145)
Charge for the year		271	271		222	222
Write down of goodwill and other intangible assets		37	37		29	29
At 31 December	12,558	1,014	13,572	12,481	1,274	13,755
Net book value at 31 December	5,606	1,010	6,616	5,558	985	6,543

Note:
(1) Principally internally generated software.

Intangible assets other than goodwill are reviewed for indicators of impairment. In 2018 £37 million (2017 - £29 million) of previously capitalised software was impaired primarily as a result of software which is no longer expected to yield future economic benefit.

The Group s goodwill acquired in business combinations analysed by reportable segment in Note 4, Segmental analysis. It is reviewed annually at 31 December for impairment. No impairment was indicated at 31 December 2018 or 2017.

Impairment testing involves the comparison of the carrying value of each cash-generating unit (CGU) with its recoverable amount. The carrying values of the segments reflect the equity allocations made by management which are consistent with the Group s capital targets. In 2018, the methodology was enhanced to reflect legal entity changes in the group. Consequently certain corporate assets, represented primarily by bonds and liquidity assets in Treasury are no longer considered to be directly attributable or directly available to the CGUs. These assets are, therefore, not included in the carrying value of the CGUs, resulting in an increase in the available headroom for some CGUs. Recoverable amount is the higher of fair value and value in use. Value in use is the present value of expected future cash flows from the CGU. Fair value is the price that would be received to sell an asset in an orderly transaction between market participants. The recoverable amounts for all CGUs at 31 December 2018 were based on value in use, using management s latest five-year revenue and cost forecasts. The long-term growth rates have been based on expected nominal growth of the CGUs. The pre-tax risk discount rates are based on those observed to be applied to businesses regarded as peers of the CGUs.

Critical accounting policy: Goodwill

Critical estimates

Impairment testing involves a number of judgmental areas: the preparation of cash flow forecasts for periods that are beyond the normal requirements of management reporting; the assessment of discount rates appropriate to each business; estimation of the fair value of the CGUs; and the valuation of separable assets of each business whose goodwill is reviewed.

The sensitivity to the more significant variables in each assessment is presented below.

The table below has not been restated for the re-segmentation which has transferred Business Banking from UK PBB to Commercial Banking. The impact was a transfer of £0.7 billion goodwill from UK PBB to Commercial Banking. This re-segmentation has improved the headroom of Commercial Banking (including Business Banking) by approximatively £4.2 billion and reduced the headroom of UK PBB by the equivalent amount without generating any impairment of the goodwill in the CGUs impacted.

		Assumptions			Consequential impact of 1% adverse movement in		Consequential impact of 5% adverse movement		Break even
	Goodwill	Terminal growth rate	Pre-tax discount rate	Recoverable amount exceeded carrying value	Discount rate	Terminal growth rate	Forecast Income	Forecast cost	discount rate
31 December 2018	£bn	%	%	£bn	£bn	£bn	£bn	£bn	%
UK Personal & Business Banking	3.4	1.8	13.1	14.4	(2.2)	(1.4)	(4.0)	(1.7)	27.7
Commercial & Private Banking	1.9	1.8	13.0	4.5	(1.2)	(0.8)	(2.3)	(1.0)	17.6
RBS International	0.3	1.8	12.9	0.7	(0.2)	(0.2)	(0.4)	(0.1)	18.5
31 December 2017									
UK Personal & Business Banking	3.4	2.0	13.1	9.7	(1.8)	(1.2)	(4.0)	(1.7)	21.6
Commercial & Private Banking	1.9	2.0	12.9	1.3	(1.2)	(0.8)	(2.4)	(1.0)	13.9
RBS International	0.3	2.0	11.0	0.6	(0.4)	(0.3)	(0.4)	(0.1)	12.8

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17 Other assets

	2018	2017
	£m	£m
Property, plant and equipment	4,351	4,602
Deferred tax (Note 7)	1,412	1,740
Assets of disposal groups (1)	1,404	195
Prepayments	435	392
Accrued income	317	378
Interests in associates (2)	404	1,410
Pension schemes in net surplus (Note 5)	520	392
Tax recoverable	37	27
Other assets	925	1,127
	9,805	10,263

Notes:

(1) Includes interest in Alawwal Bank £1,179 million (2017 - nil).

(2) Includes interest in Business Growth Fund £387 million (2017 - £316 million).

18 Other financial liabilities

	2018	2017
	£m	£m
Customer deposits		
- designated as at fair value through profit or loss	212	874
Debt securities in issue		
- designated as at fair value through profit or loss	2,628	3,403
- amortised cost	36,892	26,049
Total	39,732	30,326

19 Subordinated liabilities

	2018	2017
	£m	£m
Dated loan capital	8,262	10,394
Undated loan capital	2,127	2,169
Preference shares	146	159
	10,535	12,722

Certain preference shares issued by the company are classified as liabilities; these securities remain subject to the capital maintenance rules of the Companies Act 2006.

Notes on the consolidated accounts

19 Subordinated liabilities continued

Redemptions	Capital treatment £m	2018 £m	2017 £m
The Royal Bank of Scotland Group plc			
US$350 million 4.70% dated notes 2018	Ineligible	267	
£200 million 7.387% Series 1 non-cumulative convertible £0.01 preference shares (partial redemption)	Ineligible		15
US$1,000 million 9.118% Series 1 non-cumulative convertible preference shares of US$0.01 (partial redemption)	Ineligible		48
$156 million 7.65% Series F non-cumulative preference shares (callable)	Ineligible		120
$242 million 7.25% Series H non-cumulative preference shares (callable)	Ineligible		186
$751 million 5.75% Series L non cumulative preference shares (callable)	Ineligible		577
US$750 million 6.8% dated notes 2042 (partial redemption)	Ineligible		360
		267	1,306
NatWest Markets Plc			
2,000 million 6.934% dated notes 2018	Tier 2	1,743	
£103 million 9.5% undated subordinated bonds 2018 (callable August 2018)	Ineligible	103	
750 million 4.35% subordinated notes 2017	Tier 2		645
CHF124 million 9.375% subordinated notes 2022	Tier 2		101
CAD420 million 10.50% subordinated notes 2022	Tier 2		255
£564 million 10.50% subordinated notes 2022	Tier 2		489
AU$880 million 13.125% subordinated notes 2022	Tier 2		548
US$2,132 million 9.50% subordinated notes 2022	Tier 2		1,724
100 million floating rate subordinated notes 2017	Tier 2		90
£51 million 2.35% + 5 year UK Gilts yield undated subordinated notes (callable December 2012)	Ineligible		51
		1,846	3,903
NatWest Plc			
US$300 million 8.6250% non-cumulative preference shares (callable)	Tier 1		178
			178
NWM N.V. and subsidiaries			
US$500 million 4.65% dated notes 2018	Tier 2	141	
US$16 million floating rate notes 2019 (partial redemption)	Tier 2	2	
15 million floating rate notes 2022 (partial redemption)	Tier 2		2
250 million 4.70% notes 2019 (partial redemption)	Tier 2		80
US$500 million 4.65% notes 2018 (partial redemption)	Tier 2		244
		143	326
NatWest Holdings Limited			
£20 million 11.75% perpetual Tier 2 capital (partial redemption)	Tier 2		9
38 million 11.375% perpetual Tier 2 capital (partial redemption)	Tier 2		6
			15

There were no issuances in 2018 or 2017.

Notes on the consolidated accounts

20 Other liabilities

	2018	2017
	£m	£m
Retirement benefit liabilities (Note 5)	165	129
Deferred tax (Note 7)	454	583
Liabilities of disposal groups	1	10
Notes in circulation	2,152	2,186
Current tax	100	227
Accruals	1,047	1,074
Deferred income	451	469
Other liabilities	1,580	2,436
Provisions for liabilities and charges	3,004	7,757
	8,954	14,871

Provisions for liabilities and charges	Payment protection insurance £m	Other customer redress £m	DoJ (2) £m	Litigation and other regulatory £m	Other (3) £m	Total £m
At 1 January 2018	1,053	870	3,243	641	1,950	7,757
Implementation of IFRS 9 on 1 January 2018					85	85
ECL impairment charge					(18)	(18)
RMBS transfer			(683)	683		
Transfer from accruals and other liabilities		(4)		(4)	15	7
Currency translation and other movements		8	161	21	(1)	189
Charge to income statement	200	245	1,040	181	429	2,095
Releases to income statement		(134)		(325)	(304)	(763)
Provisions utilised	(558)	(449)	(3,761)	(414)	(1,166)	(6,348)
At 31 December 2018	695	536		783	990	3,004

Notes:

(1) Refer to Note 33 for further details on the impact of IFRS 9 on classification and basis of preparation.

(2) The RMBS provision has been redesignated DoJ and the remaining RMBS litigation matters transferred to Litigation and other regulatory as of 1 January 2018 to reflect progress on resolution.

(3) Materially comprises provisions relating to property closures and restructuring costs. At 1 January 2018 Other provisions for liabilities and charges included £800 million in respect of a package of remedies that would conclude its State Aid commitments which were paid during 2018.

Payment protection insurance

To reflect the increased volume of complaints following the FCA s introduction of an August 2019 PPI timebar as outlined in FCA announcement CP17/3 and the introduction of new Plevin (unfair commission) complaint handling rules, RBS increased its provision for PPI by £200 million in 2018 (2017 - £175 million, 2016 - £601 million, 2015 - £600 million) bringing the cumulative charge to £5.3 billion, of which £4.2 billion (79%) in redress and £0.4 billion in administrative expenses had been paid by 31 December 2018. Of the £5.3 billion cumulative charge, £4.8 billion relates to redress and £0.5 billion to administrative expenses.

The principal assumptions underlying the Group s provision in respect of PPI sales are: assessment of the total number of complaints that the Group will receive; the proportion of these that will result in redress; and the average cost of such redress. The number of complaints has been estimated from an analysis of the Group s portfolio of PPI policies sold by vintage and by product. Estimates of the percentage of policyholders that will lodge complaints (the take up rate) and of the number of these that will be upheld (the uphold rate) have been established based on recent experience, guidance in FCA policy statements and the expected rate of responses from proactive customer contact. The average redress assumption is based on recent experience and FCA calculation rules. The table below shows the sensitivity of the provision to changes in the principal assumptions (all other assumptions remaining the same).

			Sensitivity	
Assumptions	Actual to date	Future expected	Change in assumption %	Consequential change in provision £m
Customer initiated complaints (1)	2,779k	260k	+/- 5	+/- 18
Uphold rate (2)	89%	90%	+/- 1	+/- 4
Average redress (3)	£1,664	£1,512	+/- 5	+/- 18
Processing costs per claim (4)	£152	£151	+/- 20k claims	+/- 3

Notes:

(1) Claims received directly by RBS to date, including those received via CMCs and Plevin (commission) only. Excluding those for proactive mailings and where no PPI policy exists.

(2) Average uphold rate per customer initiated claims received directly by RBS including those received via CMCs, to end of timebar for both PPI (mis-sale) and Plevin (commission), excluding those for which no PPI policy exists.

(3) Average redress for PPI (mis-sale) and Plevin (commission) pay-outs.

(4) Processing costs per claim on a valid complaints basis, includes direct staff costs and associated overhead - excluding FOS fees.

Background information for all material provisions is given in Note 27

Critical accounting policy: Provisions for liabilities

Judgment is involved in determining whether an obligation exists, and in estimating the probability, timing and amount of any outflows. Where the Group can look to another party such as an insurer to pay some or all of the expenditure required to settle a provision, any reimbursement is recognised when, and only when, it is virtually certain that it will be received.

Estimates **-** Provisions are liabilities of uncertain timing or amount, and are recognised when there is a present obligation as a result of a past event, the outflow of economic benefit is probable and the outflow can be estimated reliably. Any difference between the final outcome and the amounts provided will affect the reported results in the period when the matter is resolved.

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Notes on the consolidated accounts

21 Non-controlling interests

	NWM N.V. £m	Other interests £m	Total £m
At 1 January 2017	733	62	795
Currency translation and other adjustments	22	(5)	17
Profit attributable to non-controlling interests	30	5	35
Dividends paid	(20)	(5)	(25)
Equity withdrawn and disposals	(59)		(59)
At 1 January 2018	706	57	763
Currency translation and other adjustments	24	1	25
Profit/(loss) attributable to non-controlling interests	13	(21)	(8)
Dividends paid		(5)	(5)
Equity withdrawn and disposals		(21)	(21)
At 31 December 2018	743	11	754

22 Share capital and other equity

			Number of shares	
	2018	2017	2018	2017
Allotted, called up and fully paid	£m	£m	000s	000s
Ordinary shares of £1	12,049	11,965	12,048,605	11,964,565
Non-cumulative preference shares of US$0.01 (1)			10	26,459
Non-cumulative preference shares of 0.01(2)				2,044
Non-cumulative preference shares of £1 (3)				54
Cumulative preference shares of £1	1	1	900	900

Notes:

(1) 26 million shares with a total nominal value of £0.2 million were redeemed in December 2018. (2017 46 million shares with a total nominal value of £0.3 million were redeemed).

(2) 2 million shares, with a nominal value of 20 thousand, were redeemed in December 2018.

(3) 54,442 shares, with a nominal value of £54 thousand, were redeemed in December 2018.

Movement in allotted, called up and fully paid ordinary shares	£m	Number of shares - 000s
At 1 January 2017	11,823	11,823,163

Shares issued	142	141,402
At 1 January 2018	11,965	11,964,565
Shares issued	84	84,040
At 31 December 2018	12,049	12,048,605

Ordinary shares

There is no authorised share capital under the company s constitution. At 31 December 2018, the directors had authority granted at the 2018 Annual General Meeting to issue up to £600 million nominal of ordinary shares other than by pre-emption to existing shareholders.

On 6 February 2019 RBS held a General Meeting and shareholders approved a special resolution to give authority for the Company to make off-market purchases of ordinary shares from HM Treasury (or its nominee) at such times as the Directors may determine is appropriate. Full details of the proposal are set out in the Circular and Notice of General Meeting.

During 2018, the company allotted and issued the following new ordinary shares of £1 each. The shares were allotted to UBS AG at the subscription prices determined by reference to the average market prices during the sale periods set out below:

Month	Number of shares	Subscription price per share	Sale period 2018	Gross Proceeds	Share price on allotment
April	32 million	261.7265p	23 Feb 17 Apr	£85.0m	268.4p
July	20 million	253.5641p	27 Apr 16 Jul	£50.7m	243.7p

In the three years to 31 December 2018, the percentage increase in issued share capital due to non pre-emptive issuance (excluding employee share schemes) for cash was 2.6%. In addition, the company issued 32 million ordinary shares of £1 each in connection with employee share plans.

In 2018 RBS paid an interim dividend of £241 million, or 2.0p per ordinary share. In addition, the company announced that the directors have recommended a final dividend of 3.5p per ordinary share, and a further special dividend of 7.5p per ordinary share, which are both subject to shareholders approval at the Annual General Meeting on 25 April 2019.

If approved, payment will be made on 30 April 2019 to shareholders on the register at the close of business on 22 March 2019. The ex-dividend date will be 21 March 2019. No dividend was paid in 2017.

Other securities

Additional Tier 1 Notes issued by RBS having the legal form of debt are classified as equity under IFRS. Capital recognised for regulatory purposes cannot be redeemed without Prudential Regulation Authority consent. This includes ordinary shares, preference shares and additional Tier 1 Notes.

These securities entitle the holders to interest which may be deferred at the sole discretion of the company. Repayment of the securities is at the sole discretion of the company on giving between 30 and 60 days notice.

Non-cumulative preference shares

Non-cumulative preference shares entitle their holders to periodic non-cumulative cash dividends at specified fixed rates for each Series payable out of distributable profits of the company.

The company may redeem some or all of the non-cumulative preference shares from time to time at the rates detailed in the table below plus dividends otherwise payable for the then current dividend period to the date of redemption.

In December 2018, the company redeemed in whole the Series S non-cumulative preference shares of US$0.01, Series 1,2 and 3 non-cumulative preference shares of 0.01 and Series 1 non-cumulative preference shares of £1. In December 2017, the company redeemed in whole the Series F, H, L and 1 non-cumulative preference shares of US$0.01 and Series 1 non-cumulative convertible preference shares of £0.01.

Notes on the consolidated accounts

22 Share capital and other equity continued

Non-cumulative preference shares classified as equity	Number of shares in issue	Interest rate	Redemption date on or after	Redemption price per share
Shares of US$0.01 - Series U	10,130	floating	29 September 2017	US$100,000

Note:

(1) Those preference shares where distributions are discretionary are classified as equity.

In the event that the non-cumulative convertible preference shares are not redeemed on or before the redemption date, the holder may convert them into ordinary shares in the company at the prevailing market price.

On a winding-up or liquidation of the company, the holders of the non-cumulative preference shares are entitled to receive, out of any surplus assets available for distribution to the company s shareholders (after payment of arrears of dividends on the cumulative preference shares up to the date of repayment) pari passu with the cumulative preference shares and all other shares of the company ranking pari passu with the non-cumulative preference shares as regards participation in the surplus assets of the company, a liquidation distribution per share equal to the applicable redemption price detailed in the table above, together with an amount equal to dividends for the then current dividend period accrued to the date of payment, before any distribution or payment may be made to holders of the ordinary shares as regards participation in the surplus assets of the company.

Except as described above, the holders of the non-cumulative preference shares have no right to participate in the surplus assets of the company.

Holders of the non-cumulative preference shares are not entitled to receive notice of or attend general meetings of the company except if any resolution is proposed for adoption by the shareholders of the company to vary or abrogate any of the rights attaching to the non-cumulative preference shares or proposing the winding-up or liquidation of the company. In any such case, they are entitled to receive notice of and to attend the general meeting of shareholders at which such resolution is to be proposed and are entitled to speak and vote on such resolution (but not on any other resolution). In addition, in the event that, prior to any general meeting of shareholders, the company has failed to pay in full the most recent dividend payment due on the Series U non-cumulative dollar preference shares, the holders shall be entitled to receive notice of, attend, speak and vote at such meeting on all matters together with the holders of the ordinary shares. In these circumstances only, the rights of the holders of the non-cumulative preference shares so to vote shall continue until the company shall have resumed the payment in full of the dividends in arrears.

Paid-in equity - comprises equity instruments issued by the company other than those legally constituted as shares.

	2018 £m	2017 £m	2016 £m
Additional Tier 1 notes (1)			
US$2.0 billion 7.5% notes callable August 2020 (2)	1,278	1,278	1,278
US$1.15 billion 8% notes callable August 2025 (2)	734	734	734
US$2.65 billion 8.625% notes callable August 2021 (3)	2,046	2,046	2,046
EMTN notes			
US$564 million 6.99% capital securities (redeemed October 2017)	-	-	275
CAD321 million 6.666% notes (redeemed October 2017)	-	-	156
Trust preferred issues: subordinated notes (4)			
£93 million 5.6457% 2047 (redeemed June 2017) (5)	-	-	93
	4,058	4,058	4,582

Notes:

(1) The coupons on these notes are non-cumulative and payable at the company s discretion. In the event the Group s CET1 ratio falls below 7% any outstanding notes will be converted into ordinary shares at a fixed price. While taking the legal form of debt these notes are classified as equity under IFRS.

(2) Issued in August 2015. In the event of conversion, converted into ordinary shares at a price of $3.606 nominal per £1 share.

(3) Issued in August 2016. In the event of conversion, converted into ordinary shares at a price of $2.284 nominal per £1 share.

(4) Subordinated notes issued to limited partnerships that have in turn issued partnership preferred securities to RBS Capital Trust D that issued trust preferred securities to investors.

(5) Preferred securities in issue - £93 million RBS Capital Trust D, fixed/floating rate non-cumulative trust preferred securities.

Merger reserve - the merger reserve comprises the premium on shares issued to acquire NatWest, less goodwill amortisation charged under previous GAAP.

Notes on the consolidated accounts

22 Share capital and other equity continued

Capital redemption reserve - under UK companies legislation, when shares are redeemed or purchased wholly or partly out of the company s profits, the amount by which the company s issued share capital is diminished must be transferred to the capital redemption reserve. The capital maintenance provisions of UK companies legislation apply to the capital redemption reserve as if it were part of the company s paid up share capital. On 15 June 2017, the Court of Session approved a reduction of RBSG plc capital so that the amounts which stood to the credit of the capital redemption reserve were transferred to retained earnings.

Own shares held - at 31 December 2018, 8 million ordinary shares of £1 each of the company (2017 - 16 million) were held by employee share trusts in respect of share awards and options granted to employees. During the year, the employee share trusts purchased 25 million ordinary shares and delivered 33 million ordinary shares in satisfaction of the exercise of options and the vesting of share awards under the employee share plans.

RBS optimises capital efficiency by maintaining reserves in subsidiaries, including regulated entities. Certain preference shares and subordinated debt are also included within regulatory capital. The remittance of reserves to the company or the redemption of shares or subordinated capital by regulated entities may be subject to maintaining the capital resources required by the relevant regulator.

UK law prescribes that only the reserves of the company are taken into account for the purpose of making distributions and in determining permissible applications of the share premium account.

23 Leases

	Finance lease contracts and hire purchase agreements					Operating lease assets: future minimum lease rentals
	Gross amounts	Present value adjustments	Other movements	Future drawdowns	Present value	
Year in which receipt will occur	£m	£m	£m	£m	£m	£m
2018						
Within 1 year	3,237	(208)	(123)	(70)	2,836	139
After 1 year but within 5 years	4,566	(370)	(100)		4,096	325
After 5 years	1,935	(710)	(38)		1,187	49
Total	9,738	(1,288)	(261)	(70)	8,119	513
2017						
Within 1 year	3,164	(212)	(125)	(70)	2,757	129
After 1 year but within 5 years	4,686	(444)	(94)		4,148	257

After 5 years	2,062	(742)	(27)		1,293	21
Total	9,912	(1,398)	(246)	(70)	8,198	407

	2018	2017
Nature of operating lease assets on the balance sheet	£m	£m
Transportation	313	283
Cars and light commercial vehicles	11	45
Other	285	271
	609	599

	2018	2017	2016
	£m	£m	£m
Amounts recognised as income and expense			
Finance leases - contingent rental rebate	(44)	(34)	(76)
Operating leases - minimum rentals payable	233	221	239
Finance lease contracts and hire purchase agreements			
Accumulated allowance for uncollectable minimum receivables	62	63	54

Residual value exposures

The table below gives details of the unguaranteed residual values included in the carrying value of finance lease receivables and operating lease assets.

	2018 Year in which residual value will be recovered					2017 Year in which residual value will be recovered				
	Within 1 year	After 1 year but within 2 years	After 2 years but within 5 years	After 5 years	Total	Within 1 year	After 1 year but within 2 years	After 2 years but within 5 years	After 5 years	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Operating leases										
- transportation	25	15	94	14	148	29	22	69	17	137
- cars and light commercial vehicles	1	1	2		4	5	7	7		19
- other	26	19	37	10	92	21	24	30	9	84
Finance lease contracts	68	32	67	38	205	88	20	72	27	207
Hire purchase agreements	55	2			57	38	2	1		41
	175	69	200	62	506	181	75	179	53	488

Acting as a lessor, RBS provides asset finance to its customers. It purchases plant, equipment and intellectual property, renting them to customers under lease arrangements that, depending on their terms, qualify as either operating or finance leases.

Notes on the consolidated accounts

24 Structured entities

A structured entity (SE) is an entity that has been designed such that voting or similar rights are not the dominant factor in deciding who controls the entity, for example, when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. SEs are usually established for a specific, limited purpose. They do not carry out a business or trade and typically have no employees. They take a variety of legal forms - trusts, partnerships and companies - and fulfil many different functions. As well as being a key element of securitisations, SEs are also used in fund management activities in order to segregate custodial duties from the provision of fund management advice.

Consolidated structured entities

Securitisations

In a securitisation, assets, or interests in a pool of assets, are transferred generally to an SE which then issues liabilities to third party investors. The majority of securitisations are supported through liquidity facilities or other credit enhancements.

RBS arranges securitisations to facilitate client transactions and undertakes own asset securitisations to sell or to fund portfolios of financial assets. RBS also acts as an underwriter and depositor in securitisation transactions in both client and proprietary transactions.

RBS involvement in client securitisations takes a number of forms. It may: sponsor or administer a securitisation programme; provide liquidity facilities or programme-wide credit enhancement; and purchase securities issued by the vehicle.

Own asset securitisations

In own-asset securitisations, the pool of assets held by the SE is either originated by RBS, or (in the case of whole loan programmes) purchased from third parties.

The table below analyses the asset categories for those own-asset securitisations where the transferred assets continue to be recorded on RBS balance sheet.

	2018				2017			
		Debt securities in issue				Debt securities in issue		
	Assets	Held by third parties	Held by RBS (1)	Total	Assets	Held by third parties	Held by RBS (1)	Total
Asset type	£m	£m	£m	£m	£m	£m	£m	£m
Mortgages - RoI	2,817	778	2,239	3,017	4,073		4,688	4,688
Cash deposits	221				518			
	3,038				4,591			

Note:

(1) Debt securities retained by RBS may be pledged with central banks.

Other credit risk transfer securitisations

RBS also transfers credit risk on originated loans and mortgages without the transfer of assets to an SE. As part of this, RBS enters into credit derivative and financial guarantee contracts with consolidated SEs. At 31 December 2018, debt securities in issue by such SEs (and held by third parties) were £596 million (2017 - £398 million). The associated loans and mortgages at 31 December 2018 were £8,402 million (2017 - £6,092 million).

Covered debt programme

Group companies have assigned loans to customers and debt investments to bankruptcy remote limited liability partnerships to provide security for issues of debt securities. RBS retains all of the risks and rewards of these assets and continues to recognise them. The partnerships are consolidated by RBS and the related covered bonds included within other financial liabilities. At 31 December 2018, £9,446 million (2017 - £8,915) of loans to customers and £478 million (2017 - £76 million) of debt investments provided security for debt securities in issue and other borrowing of £6,627 million (2017 - £6,307 million).

Notes on the consolidated accounts

24 Structured entities continued

Unconsolidated structured entities

RBS s interests in unconsolidated structured entities are analysed below

	2018			2017		
	Asset backed securitisation vehicles £m	Investment funds and other £m	Total £m	Asset backed securitisation vehicles £m	Investment funds and other £m	Total £m
Trading assets and derivatives						
Trading assets	590	164	754	884	131	1,015
Derivative assets	495	325	820	660	117	777
Derivative liabilities	(223)	(332)	(555)	(561)	(131)	(692)
Total	862	157	1,019	983	117	1,100
Non trading assets						
Loans to customers	1,636	544	2,180	1,243	120	1,363
Other financial assets	4,461		4,461	3,888	141	4,029
Total	6,097	544	6,641	5,131	261	5,392
Liquidity facilities/loan commitments	2,138	213	2,351	2,117	455	2,572
Guarantees	3	10	13	229	5	234
Maximum exposure	9,100	924	10,024	8,460	838	9,298

25 Asset transfers

Transfers that do not qualify for derecognition

RBS enters into securities repurchase, lending and total return transactions in accordance with normal market practice which includes the provision of additional collateral if necessary. Under standard terms in the UK and US markets, the recipient has an unrestricted right to sell or repledge collateral, subject to returning equivalent securities on settlement of the transaction.

Securities sold under repurchase transactions and transactions with the substance of securities repurchase agreements are not derecognised if RBS retains substantially all the risks and rewards of ownership. The fair value (and carrying value) of securities transferred under such transactions included on the balance sheet, are set out below. All of these securities could be sold or repledged by the holder.

The following assets have failed derecognition (1)	2018 £m	2017 £m
Trading assets	14,020	10,463
Other financial assets	9,890	13,717
	23,910	24,180

Note:

(1) Associated liabilities were £23,222 million (2017 - £23,692 million).

Assets pledged as collateral

The Group pledges collateral with its counterparties in respect of derivative liabilities and bank and other borrowings.

Assets pledged against liabilities	2018 £m	2017 £m
Trading assets	35,571	36,631
Loans to banks - amortised cost	1,050	738
Loans to customers - amortised cost	25,930	31,312
Other financial assets	713	3,397
	63,264	72,078
Liabilities secured by assets		
Bank deposits	16,326	20,226
Derivatives	21,884	22,956
	38,210	43,182

Notes on the consolidated accounts

26 Capital resources

Under Capital Requirements Regulation (CRR), regulators within the European Union monitor capital on a legal entity basis, with local transitional arrangements on the phasing in of end-point CRR.

The capital resources based on the PRA transitional basis for Bank are set out below.

	PRA transitional basis	
	2018	2017
	£m	£m
Shareholders equity (excluding non-controlling interests)		
Shareholders equity	45,736	48,330
Preference shares - equity	(496)	(2,565)
Other equity instruments	(4,058)	(4,058)
	41,182	41,707
Regulatory adjustments and deductions		
Own credit	(405)	(90)
Defined benefit pension fund adjustment	(394)	(287)
Cash flow hedging reserve	191	(227)
Deferred tax assets	(740)	(849)
Prudential valuation adjustments	(494)	(496)
Goodwill and other intangible assets	(6,616)	(6,543)
Expected losses less impairments	(654)	(1,286)
Foreseeable ordinary and special dividends	(1,326)	
Other regulatory adjustments	(105)	28
	(10,543)	(9,750)
CET1 capital	30,639	31,957
Additional Tier 1 (AT1) capital		
Qualifying instruments and related share premium	4,051	4,041
Qualifying instruments and related share premium subject to phase out	1,393	3,416
Qualifying instruments issued by subsidiaries and held by third parties subject to phase out	140	140
AT1 capital	5,584	7,597
Tier 1 capital	36,223	39,554
Qualifying Tier 2 capital		
Qualifying instruments and related share premium	6,386	6,501
Qualifying instruments issued by subsidiaries and held by third parties	1,565	1,876
Tier 2 capital	7,951	8,377
Total regulatory capital	44,174	47,931

It is RBS 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, RBS has regard to the supervisory requirements of the PRA. The PRA uses capital ratios 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 Pillar 1 capital ratios should be not less than 8% with a Common Equity Tier 1 component of not less than 4.5%. RBS has complied with the PRA s capital requirements throughout the year.

A number of subsidiaries and sub-groups within RBS, principally banking entities, are subject to various individual regulatory capital requirements in the UK and overseas. Furthermore, the payment of dividends by subsidiaries and the ability of members of RBS to lend money to other members of RBS may be subject to restrictions such as local regulatory or legal requirements, the availability of reserves and financial and operating performance.

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Notes on the consolidated accounts

27 Memorandum items

Contingent liabilities and commitments

The amounts shown in the table below are intended only to provide an indication of the volume of business outstanding at 31 December 2018. Although RBS is exposed to credit risk in the event of a customer s failure to meet its obligations, the amounts shown do not, and are not intended to, provide any indication of RBS s expectation of future losses.

	Less than 1 year £m	More than 1 year but less than 3 years £m	More than 3 years but less than 5 years £m	Over 5 years £m	2018 £m	2017 £m
Guarantees and assets pledged as collateral security	1,296	414	250	1,992	3,952	7,718
Other contingent liabilities	1,111	582	211	1,148	3,052	3,391
Standby facilities, credit lines and other commitments	61,105	20,934	32,535	5,305	119,879	124,941
Contingent liabilities and commitments	63,512	21,930	32,996	8,445	126,883	136,050

Banking commitments and contingent obligations, which have been entered into on behalf of customers and for which there are corresponding obligations from customers, are not included in assets and liabilities. RBS s maximum exposure to credit loss, in the event of its obligation crystallising and all counterclaims, collateral or security proving valueless, is represented by the contractual nominal amount of these instruments included in the table above. These commitments and contingent obligations are subject to RBS s normal credit approval processes.

Guarantees - RBS gives guarantees on behalf of customers. A financial guarantee represents an irrevocable undertaking that RBS will meet a customer s specified obligations to third party if the customer fails to do so. The maximum amount that RBS could be required to pay under a guarantee is its principal amount as in the table above. RBS expects most guarantees to expire unused.

Other contingent liabilities - these include standby letters of credit, supporting customer debt issues and contingent liabilities relating to customer trading activities such as those arising from performance and customs bonds, warranties and indemnities.

Standby facilities and credit lines - under a loan commitment, RBS agrees to make funds available to a customer in the future. Loan commitments, which are usually for a specified term, may be unconditionally cancellable or may persist, provided all conditions in the loan facility are satisfied or waived. Commitments to lend include commercial standby facilities and credit lines, liquidity facilities to commercial paper conduits and unutilised overdraft facilities.

Other commitments - these include documentary credits, which are commercial letters of credit providing for payment by RBS to a named beneficiary against presentation of specified documents, forward asset purchases, forward deposits placed and undrawn note issuance and revolving underwriting facilities, and other short-term trade related transactions.

Contractual obligations for future expenditure not provided for in the accounts

The following table shows contractual obligations for future expenditure not provided for in the accounts at the year end.

	2018 £m	2017 £m
Operating leases		
Minimum rentals payable under non-cancellable leases (1)		
- within 1 year	232	220
- after 1 year but within 5 years	736	696
- after 5 years	1,721	1,676
	2,689	2,592
Capital expenditure on property, plant and equipment	17	18
Contracts to purchase goods or services (2)	541	682
	3,247	3,292

Notes:

(1) Predominantly property leases.

(2) Of which due within 1 year: £253 million (2017 - £276 million).

Notes on the consolidated accounts

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Trustee and other fiduciary activities

In its capacity as trustee or other fiduciary role, the Group may hold or place assets on behalf of individuals, trusts, companies, pension schemes and others. The assets and their income are not included in the Group s financial statements. The Group earned fee income of £257 million (2017 - £244 million; 2016 - £251 million) from these activities.

The Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS), the UK s statutory fund of last resort for customers of authorised financial services firms, pays compensation if a firm is unable to meet its obligations. The FSCS funds compensation for customers by raising management expenses levies and compensation levies on the industry. In relation to protected deposits, each deposit-taking institution contributes towards these levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year (which runs from 1 April to 31 March), subject to annual maxima set by the Prudential Regulation Authority. In addition, the FSCS has the power to raise levies on a firm that has ceased to participate in the scheme and is in the process of ceasing to be authorised for the costs that it would have been liable to pay had the FSCS made a levy in the financial year it ceased to be a participant in the scheme.

The FSC had borrowed from HM Treasury to fund compensation costs associated with the failure of Bradford & Bingley, Heritable Bank, Kaupthing Singer & Friedlander, Landsbanki Icesave and London Scottish Bank plc. The industry has now repaid all outstanding loans with the final £4.7 billion being repaid in June 2018. The loan was interest bearing with the reference rate being the higher of 12 month LIBOR plus 111 basis points or the relevant gilt rate for the equivalent cost of borrowing from HMT.

RBS Group has accrued £1.8 million for its share of estimated FSCS levies.

Litigation, investigations and reviews

The Royal Bank of Scotland Group plc (the company or RBSG) and certain members of the Group are party to legal proceedings and the subject of investigation and other regulatory and governmental action (Matters) in the United Kingdom (UK), the United States (US), the European Union (EU) and other jurisdictions.

RBS recognises a provision for a liability in relation to these Matters when it is probable that an outflow of economic benefits will be required to settle an obligation resulting from past events, and a reliable estimate can be made of the amount of the obligation.

In many proceedings and investigations, it is not possible to determine whether any loss is probable or to estimate reliably the amount of any loss, either as a direct consequence of the relevant proceedings and investigations or as a result of adverse impacts or restrictions on RBS s reputation, businesses and operations. Numerous legal and factual issues may need to be resolved, including through potentially lengthy discovery and document production exercises and determination of important factual matters, and by addressing novel or unsettled legal questions relevant to the proceedings in question, before a liability can reasonably be estimated for any claim. RBS cannot predict if, how, or when such claims will be resolved or what the eventual settlement, damages, fine, penalty or other relief, if any, may be, particularly for claims that are at an early stage in their development or where claimants seek substantial or indeterminate damages.

There are situations where RBS may pursue an approach that in some instances leads to a settlement agreement. This may occur in order to avoid the expense, management distraction or reputational implications of continuing to contest liability, or in order to take account of the risks inherent in defending claims or investigations, even for those Matters for which RBS believes it has credible defences and should prevail on the merits. The uncertainties inherent in all such Matters affect the amount and timing of any potential outflows for both Matters with respect to which provisions have been established and other contingent liabilities.

The future outflow of resources in respect of any Matter may ultimately prove to be substantially greater than or less than the aggregate provision that RBS has recognised. Where (and as far as) liability cannot be reasonably estimated, no provision has been recognised.

Other than those discussed below, no member of the Group is or has been involved in governmental, legal or regulatory proceedings (including those which are pending or threatened) that are expected to be material, individually or in aggregate. RBS expects that in future periods, additional provisions, settlement amounts and customer redress payments will be necessary, in amounts that are expected to be substantial in some instances.

For a discussion of certain risks associated with the Group s litigation, investigations and reviews, see the Risk Factor relating to legal, regulatory and governmental actions and investigations set out on page 274.

Litigation

Residential mortgage-backed securities (RMBS) litigation in the US

RBS companies continue to defend RMBS-related claims in the US in which plaintiffs allege that certain disclosures made in connection with the relevant offerings of RMBS contained materially false or misleading statements and/or omissions regarding the underwriting standards pursuant to which the mortgage loans underlying the RMBS were issued. The remaining RMBS lawsuits against RBS companies consist of cases filed by the Federal Home Loan Banks of Boston and Seattle and the Federal Deposit Insurance Corporation that together involve the issuance of less than US$1 billion of RMBS issued primarily from 2005 to 2007. In addition, NatWest Markets Securities Inc. previously agreed to settle a purported RMBS class action entitled New Jersey Carpenters Health Fund v. Novastar Mortgage Inc. et al. for US$55.3 million, which has been paid into escrow pending court approval of the settlement.

London Interbank Offered Rate (LIBOR) and other rates litigation

NatWest Markets Plc and certain other members of the Group, including RBSG, are defendants in a number of class actions and individual claims pending in the US (primarily in the United States District Court for the Southern District of New York (SDNY)) with respect to the setting of LIBOR and certain other benchmark interest rates. The complaints allege that certain members of the Group and other panel banks violated various federal laws, including the US commodities and antitrust laws, and state statutory and common law, as well as contracts, by manipulating LIBOR and prices of LIBOR-based derivatives in various markets through various means.

Several class actions relating to USD LIBOR, as well as more than two dozen non-class actions concerning USD LIBOR, are part of a coordinated proceeding in the SDNY. In December 2016, the SDNY held that it lacks personal jurisdiction over NatWest Markets Plc with respect to certain claims. As a result of that decision, all Group companies have been dismissed from each of the USD LIBOR-related class actions (including class actions on behalf of over-the-counter plaintiffs, exchanged-based purchaser plaintiffs, bondholder plaintiffs, and lender plaintiffs), but six non-class cases in the coordinated proceeding remain pending against Group defendants. The dismissal of Group companies for lack of personal jurisdiction is the subject of a pending appeal to the United States Court of Appeals for the Second Circuit.

Among the non-class claims dismissed by the SDNY in December 2016 were claims that the Federal Deposit Insurance Corporation (FDIC) had asserted on behalf of certain failed US banks. On 10 July 2017, the FDIC, on behalf of 39 failed US banks, commenced substantially similar claims against RBS companies and others in the High Court of Justice of England and Wales. The action alleges that the defendants breached

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Litigation, investigations and reviews

English and European competition law as well as asserting common law claims of fraud under US law.

In addition, there are two class actions relating to JPY LIBOR and Euroyen TIBOR, both pending before the same judge in the SDNY. In the first class action, which relates to Euroyen TIBOR futures contracts, the court dismissed the plaintiffs antitrust claims in March 2014, but declined to dismiss their claims under the Commodity Exchange Act for price manipulation, and the case is proceeding in the discovery phase. The second class action relates to other derivatives allegedly tied to JPY LIBOR and Euroyen TIBOR. The court dismissed that case on 10 March 2017 on the ground that the plaintiffs lack standing. The plaintiffs have commenced an appeal of that decision.

There is also a class action relating to the Singapore Interbank Offered Rate and Singapore Swap Offer Rate pending in the SDNY. In that case, the court denied defendants motion to dismiss on 5 October 2018. The court s ruling would permit certain antitrust claims to proceed against NatWest Markets Plc and other non-RBS defendants, however, in November 2018, the defendants filed another motion to dismiss plaintiffs claims.

Four other class action complaints were filed against RBS companies in the SDNY, each relating to a different reference rate. In the case relating to Pound Sterling LIBOR, the court dismissed all claims against RBS companies, for various reasons, on 21 December 2018, and plaintiffs are seeking reconsideration of that decision. In the case relating to the Australian Bank Bill Swap Reference Rate, the court dismissed all claims against RBS companies for lack of personal jurisdiction on 26 November 2018, but plaintiffs have filed an amended complaint, which will be the subject of a further motion to dismiss. In the case relating to Euribor, the court dismissed all claims against RBS companies for lack of personal jurisdiction on 21 February 2017. In the case relating to Swiss Franc LIBOR, the court dismissed all claims against all defendants on various grounds on 25 September 2017, but held that it has personal jurisdiction over NatWest Markets Plc and allowed the plaintiffs to replead their complaint. Defendants renewed motion to dismiss the amended complaint relating to Swiss Franc LIBOR remains pending.

NatWest Markets Plc has also been named as a defendant in a motion to certify a class action relating to LIBOR in the Tel Aviv District Court in Israel.

NatWest Markets Plc is defending a claim in the High Court in London brought by London Bridge Holdings Ltd and others, in which the claimants allege LIBOR manipulation in connection with the sale of interest rate hedging products. The sum claimed in that case is £446.7 million.

On 4 February 2019, a claim was issued against NatWest Markets Plc by London Borough of Newham, in respect of certain lender option borrower option (LOBO) loans.

Details of UK litigation claims in relation to the alleged mis-sale of interest rate hedging products (IRHPs) involving LIBOR-related allegations are set out under Interest rate hedging products litigation on page 236.

In January 2019, a class action antitrust complaint was filed in the SDNY alleging that the defendants (USD ICE LIBOR panel banks and affiliates) have conspired to suppress USD ICE LIBOR from 2014 to the present by submitting incorrect information to ICE about their borrowing costs. The RBS defendants are RBSG, NatWest Markets Plc, NatWest Markets Securities Inc., and NatWest Plc.

FX antitrust litigation

NatWest Markets Plc and certain other members of the Group, including RBSG, are defendants in several cases relating to NatWest Markets Plc s foreign exchange (FX) business, each of which is pending before the same federal judge in the SDNY.

In 2015, RBS companies paid US$255 million to settle the consolidated antitrust class action on behalf of persons who entered into over-the-counter FX transactions with defendants or who traded FX instruments on exchanges. That settlement received final court approval in August 2018. On 7 November 2018, some members of the settlement class who opted out of the settlement filed their own non-class complaint in the SDNY asserting antitrust claims against RBS companies and others. On 31 December 2018, some of the same claimants, as well as others, filed proceedings in the High Court in London, asserting competition claims against NatWest Markets Plc and several other banks.

Two other FX-related class actions remain pending. First, there is a class action on behalf of consumers and end-user businesses, which is proceeding in the discovery phase following the SDNY s denial of the defendants motions to dismiss in March 2018. Second, there is a class action on behalf of indirect purchasers of FX instruments (which plaintiffs define as persons who transacted FX instruments with retail foreign exchange dealers that transacted directly with defendant banks). That case is also proceeding in discovery following the SDNY s denial of defendants motion to dismiss on 25 October 2018.

RBS companies have also been named as defendants in two motions to certify FX-related class actions in the Tel Aviv District Court in Israel.

Certain other foreign exchange transaction related claims have been or may be threatened against RBS companies. RBS cannot predict whether any of these claims will be pursued, but expects that some may.

US Treasury securities antitrust litigation

NatWest Markets Securities Inc. is a defendant in a consolidated antitrust class action pending in the SDNY on behalf of persons who transacted in US Treasury securities or derivatives based on such instruments, including futures and options. The plaintiffs allege that defendants rigged the US Treasury securities auction bidding process to deflate prices at which they bought such securities and colluded to increase the prices at which they sold such securities to plaintiffs. The defendants motion to dismiss this matter remains pending.

Swaps antitrust litigation

NatWest Markets Plc and other members of the Group, including RBSG, as well as a number of other interest rate swap dealers, are defendants in several cases pending in the SDNY alleging violations of the US antitrust laws in the market for interest rate swaps. There is a consolidated class action complaint on behalf of persons who entered into interest rate swaps with the defendants, as well as non-class action claims by three swap execution facilities (TeraExchange, Javelin, and trueEx). The plaintiffs allege that the swap execution facilities would have successfully established exchange-like trading of interest rate swaps if the defendants had not unlawfully conspired to prevent that from happening through boycotts and other means. Discovery in these cases is ongoing.

In addition, on 8 June 2017, TeraExchange filed a complaint against RBS companies, including RBSG, as well as a number of other credit default swap dealers, in the SDNY. TeraExchange alleges it would have established exchange-like trading of credit default swaps if the defendant dealers had not engaged in an unlawful antitrust conspiracy. On 1 October 2018, the court dismissed all claims against RBS companies.

Madoff

NatWest Markets N.V. (NWM N.V.) is a defendant in two actions filed by Irving Picard, as trustee for the bankruptcy estates of Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC, in bankruptcy court in New York. In both cases, the trustee alleges that certain transfers received by NatWest Markets N.V. amounted to fraudulent conveyances that should be clawed back for the benefit of the Madoff estate.

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In the primary action, filed in December 2010, the trustee originally sought to recover US$75.8 million in redemptions that NWM N.V. allegedly received from certain Madoff feeder funds and US$162.1 million that NWM N.V. allegedly received from certain swap counterparties. In August 2018, the trustee voluntarily dismissed a portion of this claim (relating to US$74.6 million received from certain swap counterparties) without prejudice to-refiling at a later date. Otherwise this action remains pending before the bankruptcy court, where it will in due course be the subject of a motion to dismiss. In the second action, filed in October 2011, the trustee seeks to recover an additional US$21.8 million. In November 2016, the bankruptcy court dismissed this case on international comity grounds, and that decision is currently on appeal to the United States Court of Appeals for the Second Circuit.

Thornburg adversary proceeding

Certain RBS companies were defendants in an adversary proceeding filed in the US bankruptcy court in Maryland by the trustee for TMST, Inc. (formerly known as Thornburg Mortgage, Inc.). The trustee sought recovery of transfers made under certain restructuring agreements as avoidable fraudulent and preferential transfers. On 26 October 2018, the bankruptcy court approved a US$23.5 million settlement of this matter. RBS companies have paid this settlement amount, which was covered by a provision existing as of 30 September 2018.

Interest rate hedging products and similar litigation

RBS is dealing with a number of active litigation claims in the UK in relation to the alleged mis-selling of interest rate hedging products (IRHPs). In general claimants allege that the relevant IRHPs were mis-sold to them, with some also alleging that misrepresentations were made in relation to LIBOR. Claims have been brought by customers who were considered under the UK Financial Conduct Authority (FCA) redress programme for IRHPs, as well as customers who were outside of the scope of that programme, which was closed to new entrants on 31 March 2015. RBS remains exposed to potential claims from customers who were either ineligible to be considered for redress or who are dissatisfied with their redress offers.

Property Alliance Group (PAG) v NatWest Markets Plc was the leading case before the English High Court involving both IRHP mis-selling and LIBOR misconduct allegations. The amount claimed was £34.8 million and the trial ended in October 2016. In December 2016 the Court dismissed all of PAG s claims. PAG appealed that decision, and the Court of Appeal s judgment dismissing the appeal was handed down on 2 March 2018. On 24 July 2018 the Supreme Court declined the request from PAG for permission to appeal an aspect of the judgment relating to implied representations of Sterling LIBOR rates. The Court of Appeal s decision may impact other IRHP and LIBOR-related cases currently pending in the English courts, some of which involve substantial amounts.

Separately, NatWest Markets Plc is defending claims filed in France by five French local authorities relating to structured interest rate swaps. The plaintiffs allege, among other things, that the swaps are void for being illegal transactions, that they were mis-sold, and that information / advisory duties were breached. One of the claims is now at an end following the Court of Appeal s dismissal of the claim, and is not being appealed to the Supreme Court. Three of the claims were also dismissed but are subject to appeal to the Supreme Court. The fifth claim remains to be heard before the lower courts.

Tax dispute

HMRC issued a tax assessment in 2012 against NatWest Markets Plc for approximately £86 million regarding a value-added-tax (VAT) matter in relation to the trading of European Union Allowances (EUAs) by an RBS joint venture subsidiary in 2009. RBS has lodged an appeal, which is still to be heard, before the First-tier Tribunal (Tax), a specialist tax tribunal, challenging the assessment (the Tax Dispute). In the event that the assessment is upheld, interest and costs would be payable, and a penalty of up to 100 per cent of the VAT held to have been legitimately denied by HMRC could also be levied. Separately, RBS is a named defendant in civil proceedings before the High Court brought in 2015 by ten companies (all in liquidation) (the Liquidated Companies) and their respective liquidators (together, the Claimants). The Liquidated Companies previously traded in EUAs in 2009 and are alleged to be defaulting traders within (or otherwise connected to) the EUA supply chains forming the subject of the Tax Dispute. The Claimants claim approximately £71.4 million plus interest and costs and allege that NatWest Markets Plc dishonestly assisted the directors of the Liquidated Companies in the breach of their statutory duties and/or knowingly participated in the carrying on of the business of the Liquidated Companies with intent to defraud creditors. The trial in that matter concluded on 20 July 2018 and judgment is awaited.

US Anti-Terrorism Act litigation

NatWest Plc is defending lawsuits filed in the United States District Court for the Eastern District of New York by a number of US nationals (or their estates, survivors, or heirs) who were victims of terrorist attacks in Israel. The plaintiffs allege that NatWest Plc is liable for damages arising from those attacks pursuant to the US Anti-Terrorism Act because NatWest Plc previously maintained bank accounts and transferred funds for the Palestine Relief & Development Fund, an organisation which plaintiffs allege solicited funds for Hamas, the alleged perpetrator of the attacks.

In October 2017, the trial court dismissed claims against NatWest Plc with respect to two of the 18 terrorist attacks at issue. On 14 March 2018, the trial court granted a request by NatWest Plc for leave to file a renewed summary judgment motion in respect of the remaining claims, which has now been filed. No trial date has been set.

NatWest Markets N.V. and certain other financial institutions, are defendants in several actions pending in the United States District Courts for the Eastern and Southern Districts of New York, filed by a number of US nationals (or their estates, survivors, or heirs), most of whom are or were US military personnel, who were killed or injured in attacks in Iraq between 2003 and 2011. NatWest Markets Plc is also a defendant in some of these cases.

The attacks at issue in the cases were allegedly perpetrated by Hezbollah and certain Iraqi terror cells allegedly funded by the Islamic Republic of Iran. According to the plaintiffs allegations, the defendants are liable for damages arising from the attacks because they allegedly conspired with Iran and certain Iranian banks to assist Iran in transferring money to Hezbollah and the Iraqi terror cells, in violation of the US Anti-Terrorism Act, by agreeing to engage in stripping of transactions initiated by the Iranian banks so that the Iranian nexus to the transactions would not be detected. The first of these actions was filed in the United States District Court for the Eastern District of New York in November 2014. On 27 July 2018, the magistrate judge in that case issued a report to the district court recommending that the district court deny the defendants pending motion to dismiss. NatWest Markets N.V. has requested that the district court grant the motion to dismiss notwithstanding the magistrate s recommendation. The other actions are either subject to a pending motion to dismiss, or will be the subject of such a motion in due course.

Securities underwriting litigation

NatWest Markets Securities Inc. is an underwriter defendant in several securities class actions in the US in which plaintiffs generally allege that an issuer of public debt or equity securities, as well as the underwriters of the securities (including NatWest Markets Securities Inc.), are liable to purchasers for misrepresentations and omissions made in connection with the offering of such securities.

Investigations and reviews

RBS s businesses and financial condition can be affected by the actions

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Litigation, investigations and reviews

of various governmental and regulatory authorities in the UK, the US, the EU and elsewhere. RBS has engaged, and will continue to engage, in discussions with relevant governmental and regulatory authorities, including in the UK, the US, the EU and elsewhere, on an ongoing and regular basis, and in response to informal and formal inquiries or investigations, regarding operational, systems and control evaluations and issues including those related to compliance with applicable laws and regulations, including consumer protection, business conduct, competition/anti-trust, anti-bribery, anti-money laundering and sanctions regimes.

The NatWest Markets business in particular has been providing, and continues to provide, information regarding a variety of matters, including, for example, the setting of benchmark rates and related derivatives trading, conduct in the foreign exchange market, and various issues relating to the issuance, underwriting, and sales and trading of fixed-income securities, including structured products and government securities, some of which have resulted, and others of which may result, in investigations or proceedings.

Any matters discussed or identified during such discussions and inquiries may result in, among other things, further inquiry or investigation, other action being taken by governmental and regulatory authorities, increased costs being incurred by RBS, remediation of systems and controls, public or private censure, restriction of RBS s business activities and/or fines. Any of the events or circumstances mentioned in this paragraph or below could have a material adverse effect on RBS, its business, authorisations and licences, reputation, results of operations or the price of securities issued by it.

RBS is co-operating fully with the investigations and reviews described below.

RMBS and other securitised products investigations

In the US, RBS companies have in recent years been involved in investigations relating to, among other things, issuance, underwriting and trading in RMBS and other mortgage-backed securities and collateralised debt obligations (CDOs).

Investigations by the US Department of Justice (DoJ) and certain state attorneys general relating to the issuance and underwriting of RMBS were resolved in 2018. Certain other state attorneys general have sought information regarding similar issues, and RBS is aware that at least one such investigation is ongoing.

In October 2017, NatWest Markets Securities Inc. entered into a non-prosecution agreement (NPA) with the United States Attorney for the District of Connecticut (USAO) in connection with alleged misrepresentations to counterparties relating to secondary trading in various forms of asset-backed securities. As part of the NPA, the USAO agreed not to file criminal charges relating to certain conduct and information described in the NPA if NatWest Markets Securities Inc. complies with the terms of the NPA. In October 2018, NatWest Markets Securities Inc. agreed to a six-month extension of the NPA while the USAO reviews the circumstances of an unrelated matter reported during the course of the NPA.

US mortgages - loan repurchase matters

RBS s NatWest Markets business in North America was a purchaser of non-agency residential mortgages in the secondary market, and an issuer and underwriter of non-agency RMBS, and, in some circumstances, made certain representations and warranties regarding the characteristics of the underlying loans. As a result, NatWest Markets may be, or may have been, contractually required to repurchase such loans or indemnify certain parties against losses for certain breaches of such representations and warranties. Depending on the extent to which such loan repurchase related claims are pursued against and not rebutted by NatWest Markets on timeliness or other grounds, the aggregate potential impact on RBS, if any, may be material.

Foreign exchange related investigations

In 2014 and 2015, NatWest Markets Plc paid significant penalties to resolve investigations into its FX business by the FCA, the CFTC, the DoJ, and the Board of Governors of the Federal Reserve System (Federal Reserve). As part of its plea agreement with the DoJ, NatWest Markets Plc pled guilty to a one-count information charging an antitrust conspiracy occurring between as early as December 2007 to at least April 2010. NatWest Markets Plc admitted that it knowingly, through one of its euro/US dollar currency traders, joined and participated in a conspiracy to eliminate competition in the purchase and sale of the euro/US dollar currency pair exchanged in the FX spot market. On 5 January 2017, the United States District Court for the District of Connecticut imposed a sentence on NatWest Markets Plc consisting of a US$395 million fine and a three-year probation, which among other things, prohibits NatWest Markets Plc from committing another crime in violation of US law or engaging in the FX trading practices that form the basis for the charged crime and requires NatWest Markets Plc to implement a compliance program designed to prevent and detect the unlawful conduct at issue and to strengthen its compliance and internal controls as required by other regulators (including the FCA and the CFTC). A violation of the terms of probation could lead to the imposition of additional penalties.

As part of the settlement with the Federal Reserve, NatWest Markets Plc and NatWest Markets Securities Inc. entered into a cease and desist order (the FX Order). In the FX Order, which is publicly available and will remain in effect until terminated by the Federal Reserve, NatWest Markets Plc and NatWest Markets Securities Inc. agreed to take certain remedial actions with respect to FX activities and certain other designated market activities, including the creation of an enhanced written internal controls and compliance program, an improved compliance risk management program, and an enhanced internal audit program. NatWest Markets Plc and NatWest Markets Securities Inc. are obligated to implement and comply with these programs as approved by the Federal Reserve, and are also required to conduct, on an annual basis, a review of applicable compliance policies and procedures and a risk-focused sampling of key controls.

NatWest Markets Plc is co-operating with investigations and responding to inquiries from other governmental and regulatory (including competition) authorities on similar issues relating to failings in its FX business. The timing and amount of financial penalties with respect to any further settlements and related litigation risks and collateral consequences remain uncertain and may well be material.

FCA review of RBS s treatment of SMEs

In 2014, the FCA appointed an independent Skilled Person under section 166 of the Financial Services and Markets Act 2000 to review RBS s treatment of SME customers whose relationship was managed by RBS s Global Restructuring Group (GRG) in the period 1 January 2008 to 31 December 2013.

The Skilled Person delivered its final report to the FCA during September 2016, and the FCA published an update in November 2016. In response, RBS announced redress steps for SME customers in the UK and the Republic of Ireland that were in GRG between 2008 and 2013. These steps were (i) an automatic refund of certain complex fees; and (ii) a new complaints process, overseen by an independent third party. The complaints process closed on 22 October 2018 for new complaints in the UK and, with the exception of a small cohort of potential complainants for whom there is an extended deadline, on 31 December 2018 for new complaints in the Republic of Ireland.

RBS made a provision of £400 million in 2016, in respect of the above redress steps, of which £270 million had been utilised by 31 December 2018. An additional provision of £50 million was taken at 31 December 2018 reflecting the increased costs of the complaints process.

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Litigation, investigations and reviews

The FCA published a summary of the Skilled Person s report in November 2017.The UK House of Commons Treasury Select Committee, seeking to rely on Parliamentary powers, published the full version of the Skilled Person s report on 20 February 2018. On 31 July 2018, the FCA confirmed that it had concluded its investigation and that it does not intend to take disciplinary or prohibitory action against any person in relation to these matters. It has subsequently indicated that it will shortly publish a final summary of its investigative work.

Investment advice review

As a result of an FSA review in 2013, the FCA required RBS to carry out a past business review and customer contact exercise on a sample of historic customers who received investment advice on certain lump sum products, during the period from March 2012 until December 2012. The review was conducted by an independent Skilled Person under section 166 of the Financial Services and Markets Act 2000. Redress was paid to certain customers in that sample group.

RBS later agreed with the FCA that it would carry out a wider review/remediation exercise relating to certain investment, insurance and pension sales from 1 January 2011 to 1 April 2015. That exercise is materially complete. Phase 2 (covering sales in 2010) started in April 2018 and was targeted for completion by the end of 2018, however the deadline has now been extended to April 2019.

In addition, RBS agreed with the FCA that it would carry out a remediation exercise, for a specific customer segment who were sold a particular structured product. Redress was paid to certain customers who took out the structured product.

RBS provisions in relation to these matters totalled £206 million as at 31 December 2018, of which £144 million had been utilised by that date.

Packaged accounts

RBS has had dedicated resources in place since 2013 to investigate and resolve packaged account complaints on an individual basis. RBS provisions for this matter totalled £444 million as at 31 December 2018. The FCA conducted a thematic review of packaged bank accounts across the UK from October 2014 to April 2016, the results of which were published in October 2016. RBS made amendments to its sales process and complaints procedures to address the findings from that review.

FCA investigation into RBS s compliance with the Money Laundering Regulations 2007

On 21 July 2017, the FCA notified RBS that it was undertaking an investigation into RBS s compliance with the Money Laundering Regulations 2007 in relation to certain customers. Following amendment to the scope of the investigation, there are currently two areas under review: (1) compliance with Money Laundering Regulations in respect of Money Service Business customers; and (2) the Suspicious Transactions regime in relation to the events surrounding particular customers. The investigations in both areas are assessing both criminal and civil culpability. RBS is cooperating with the investigations, including responding to several information requests from the FCA.

Systematic Anti-Money Laundering Programme assessment

In December 2018, the FCA commenced a Systematic Anti-Money Laundering Programme assessment of RBS. RBS is responding to requests for information from the FCA.

Payment Protection Insurance (PPI)

Since 2011, RBS has been implementing the FCA s policy statement for the handling of complaints about the mis-selling of PPI (Policy Statement 10/12). In August 2017, the FCA s new rules and guidance on PPI complaints handling (Policy Statement 17/3) came into force. The Policy Statement introduced new so called Plevin rules, under which customers may be eligible for redress if the bank earned a high level of commission from the sale of PPI, but did not disclose this detail at the point of sale. The Policy Statement also introduced a two year PPI deadline, due to expire in August 2019, before which new PPI complaints must be made. RBS is implementing the Policy Statement.

RBS has made provisions totalling £5.3 billion to date for PPI claims, including an additional provision of £200 million taken at Q3 2018, reflecting greater than predicted complaints volumes. Of the £5.3 billion cumulative provision, £4.7 billion had been utilised by 31 December 2018.

FCA mortgages market study

In December 2016, the FCA launched a market study into the provision of mortgages. On 4 May 2018 the interim report was published. This found that competition was working well for many customers but also proposed remedies to help customers shop around more easily for mortgages. Following a period of consultation, the final report is due to be published in Q1 2019.

FCA strategic review of retail banking models

On 11 May 2017 the FCA announced a strategic review of retail banking models. The FCA used the review to understand how these models operate, including how free if in credit banking is paid for and the impact of changes such as increased use of digital channels and reduced branch usage.

On 18 December 2018, the FCA published its final report containing a number of findings, including that personal current accounts are an important source of competitive advantage for major banks. Following the review, the FCA is to continue to monitor retail banking models, analyse new payments business models and undertake exploratory work to understand certain aspects of SME banking.

US/Swiss tax programme

In December 2015, Coutts & Co Ltd., a member of the Group incorporated in Switzerland, entered into a non-prosecution agreement (the NPA) with the DoJ. This was entered into as part of the DoJ s programme for Swiss banks, related to its investigations of the role that Swiss banks played in concealing the assets of US tax payers in offshore accounts (US related accounts). Coutts & Co Ltd. paid a US$78.5 million penalty and acknowledged responsibility for certain conduct set forth in a statement of facts accompanying the agreement. Under the NPA, which has a term of four years, Coutts & Co Ltd. is required, among other things, to provide certain information, cooperate with the DoJ s investigations, and commit no U.S. federal offences. If Coutts & Co Ltd. abides by the NPA, the DoJ will not prosecute it for certain tax-related and monetary transaction offences in connection with US related accounts.

Since the signing of the NPA in 2015, Coutts & Co Ltd has identified and disclosed to the DoJ a number of US related accounts that were not included in its original submission supporting the NPA. Coutts & Co Ltd is in discussions with the DoJ regarding these additional accounts and has agreed with the DoJ to undertake additional review work, which is ongoing.

Enforcement proceedings and investigations in relation to Coutts & Co Ltd

In February 2017, the Swiss Financial Market Supervisory Authority (FINMA) took enforcement action against Coutts & Co Ltd with regard to failures of money laundering checks and controls on certain client accounts that were connected with the Malaysian sovereign wealth fund, 1MDB, and were held with Coutts & Co Ltd. FINMA accordingly required Coutts & Co Ltd to disgorge profits of CHF 6.5 million. There are two administrative criminal proceedings pending before the Swiss Finance Department against two former employees of Coutts & Co Ltd. In addition, the Monetary Authority of Singapore (MAS) s supervisory examination of Coutts & Co Ltd s Singapore branch revealed breaches of anti-money laundering requirements. MAS imposed on Coutts & Co Ltd financial penalties amounting to SGD 2.4 million in December 2016.

Notes on the consolidated accounts

27 Memorandum items continued

Litigation, investigations and reviews

In addition, Coutts & Co Ltd continues to assist with investigations and enquiries from authorities where requested to do so.

Regulator requests concerning certain historic Russian transactions

Media coverage in 2017 highlighted an alleged money laundering scheme involving Russian entities between 2010 and 2014. Allegedly certain European banks, including RBS and 16 other UK based financial institutions, and certain US banks, were involved in processing certain transactions associated with this scheme. RBS has responded to requests for information from the FCA, PRA and regulators in other jurisdictions.

Review and investigation of treatment of tracker mortgage customers in Ulster Bank Ireland DAC

In December 2015, the Central Bank of Ireland (CBI) announced that it had written to a number of lenders requiring them to put in place a robust plan and framework to review the treatment of customers who have been sold mortgages with a tracker interest rate or with a tracker interest rate entitlement. The CBI stated that the intended purpose of the review was to identify any cases where customers contractual rights under the terms of their mortgage agreements were not fully honoured, or where lenders did not fully comply with various regulatory requirements and standards regarding disclosure and transparency for customers. The CBI has required Ulster Bank Ireland DAC (UBI DAC), a member of the Group incorporated in the Republic of Ireland, to participate in this review and UBI DAC is co-operating with the CBI in this regard. UBI DAC submitted its phase 2 report to the CBI in March 2017, identifying impacted customers. The redress and compensation phase (phase 3) commenced in Q4 2017 and is ongoing.

RBS has made provisions totalling 297 million (£266 million) to date for this matter. Of the 297 million (£266 million) cumulative provision, 211million (£189 million) had been utilised by 31 December 2018.

Separately, in April 2016, the CBI notified UBI DAC that it was also commencing an investigation under its Administrative Sanctions Procedure into suspected breaches of the Consumer Protection Code 2006 during the period 4 August 2006 to 30 June 2008 in relation to certain customers who switched from tracker mortgages to fixed rate mortgages. This investigation is ongoing and UBI DAC continues to co-operate with the CBI.

As part of an internal review of the wider retail and commercial loan portfolios extending from the tracker mortgage examination programme, UBI DAC identified further legacy business issues. A programme is ongoing to identify and remediate impacted customers. RBS has made provisions totalling 167 million (£150 million) based on expected remediation and project costs of which 41 million (£37 million) had been utilised by 31 December 2018.

28 Analysis of the net investment in business interests and intangible assets

	2018	2017	2016
Acquisitions and disposals	£m	£m	£m
Fair value given for businesses acquired (1)	(113)	(131)	(87)
Additional investment in associates	(9)		
Net outflow of cash in respect of acquisitions	(122)	(131)	(87)
Net assets/(liabilities) sold		177	(400)
Non-cash consideration		(15)	(5)
Profit on disposal		155	22
Net cash and cash equivalents disposed			55
Net inflow/(outflow) of cash in respect of disposals		317	(328)
Dividends received from associates	5	(1)	9
Cash expenditure on intangible assets	(364)	(384)	(480)
Net (outflow)/inflow	(481)	(199)	(886)

Note:

(1) 2018 includes the purchase of Free agent.

29 Analysis of changes in financing during the year

	Share capital, share premium, paid-in equity and merger reserve			Subordinated liabilities		
	2018	2017	2016	2018	2017	2016
	£m	£m	£m	£m	£m	£m
At 1 January	27,791	52,979	50,577	12,722	19,419	19,847
Issue of ordinary shares	144	306	300			
Issue of Additional Tier 1 capital notes			2,046			
Redemption of paid-in equity		(720)	(110)			
Redemption of subordinated liabilities				(2,258)	(5,747)	(3,606)
Net cash (outflow)/inflow from financing	144	(414)	2,236	(2,258)	(5,747)	(3,606)
Transfer to retained earnings		(25,789)				
Ordinary shares issued in respect of employee share schemes	80	71	166			
Redemption of debt preference shares		748				
Other adjustments including foreign exchange		196		71	(950)	3,178
At 31 December	28,015	27,791	52,979	10,535	12,722	19,419

Notes on the consolidated accounts

30 Analysis of cash and cash equivalents

	2018 £m	2017 £m	2016 £m
At 1 January			
- cash	98,337	88,414	94,832
- cash equivalents	24,268	10,156	8,760
	122,605	98,570	103,592
Net cash outflow	(13,794)	24,035	(5,022)
At 31 December	108,811	122,605	98,570
Comprising:			
Cash and balances at central banks	88,897	98,337	74,250
Treasury bills and debt securities	83	427	387
Net loans to banks	19,831	23,841	23,933
Cash and cash equivalents	108,811	122,605	98,570

Note:

(1) Includes cash collateral posted with bank counterparties in respect of derivative liabilities of £7,302 million (2017 - £6,883 million; 2016 - £6,661 million).

Certain members of RBS are required by law or regulation to maintain balances with the central banks in the jurisdictions in which they operate. These balances are set out below.

	2018	2017	2016
Bank of England	£0.9bn	£0.6bn	£0.5bn
De Nederlandsche Bank	0.1bn	0.1bn	0.4bn

31 Directors and key management remuneration

Directors remuneration	2018 £000	2017 £000
Non Executive Directors	2,001	1,747
Chairman and executive directors		
-emoluments	4,657	5,299
	6,658	7,046
Amounts receivable under long-term incentive plans and share option plans		1,225
Total	6,658	8,271

No directors accrued benefits under defined benefit schemes or money purchase schemes during 2018 and 2017.

The executive directors may participate in the company s long-term incentive plans, executive share option and sharesave schemes and details of their interests in the company s shares arising from their participation are given in the Directors remuneration report. Details of the remuneration received by each director are also given in the Directors remuneration report.

Compensation of key management

The aggregate remuneration of directors and other members of key management during the year was as follows:

	2018	2017
	£000	£000
Short-term benefits	20,316	19,019
Post-employment benefits	82	434
Share-based payments		3,558
	20,398	23,011

A new board and committee operating model was introduced in 2018 in order to align with UK ring-fencing requirements. The definition of key management has been revised and now comprises members of the RBSG and NWH Ltd Boards, members of the RBSG and NWH Ltd Executive Committees, and the Chief Executives of NatWest Markets Plc and RBS International. This is on the basis that these individuals have been identified as Persons Discharging Managerial Responsibilities (PDMRs) of RBSG under the new governance structure.

32 Transactions with directors and key management

At 31 December 2018, amounts outstanding in relation to transactions, arrangements and agreements entered into by authorised institutions in the Group, as defined in UK legislation, were £9,660 in respect of loans to five persons who were directors of the company at any time during the financial period.

For the purposes of IAS 24 Related Party Disclosures , key management comprise directors of the company and Persons Discharging Managerial Responsibilities (PDMRs) of RBSG under the new governance structure. The captions in the Group s primary financial statements include the following amounts attributable, in aggregate, to key management:

	2018	2017
	£000	£000
Loans to customers	1,544	3,942
Customer deposits	31,361	23,619

Key management have banking relationships with Group entities which are entered into in the normal course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with other persons of a similar standing or, where applicable, with other employees. These transactions did not involve more than the normal risk of repayment or present other unfavourable features.

Notes on the consolidated accounts

33 Adoption of IFRS 9

The Group s accounting policies have significantly changed on the adoption of IFRS 9 Financial Instruments with effect from 1 January 2018. Prior years are re-presented but there has been no restatement of prior year data.

IFRS 9 changed the classification categories of financial assets from IAS 39. Held-for-trading assets were classified to mandatory fair value through profit or loss; loans and receivables were classified to amortised cost; and available-for-sale assets were classified as fair value through other comprehensive income unless they were deemed to be in a fair value business model or failed the contractual cash flow requirements under IFRS 9. There were no changes in the classification and measurement of financial liabilities.

Loans to customers of £2.1 billion were reclassified from loans and receivables under IAS 39 to fair value through profit or loss under IFRS 9. As a result, their carrying value increased by £583 million.

The net increase to loan impairments under IAS 39 was £616 million under the expected credit loss requirements of IFRS 9, including £85 million under provisions for contingent liabilities and commitments. This includes discontinued activities which is shown below on other assets and other liabilities

The impact on the Group s balance sheet at 1 January 2018 and the key movements in relation to the impact on classification and measurement, expected credit losses and tax are as follow:

	Changes to presentation				IFRS 9 impact			
	31 December 2017 (IAS 39)	Held-for-trading exported to trading assets/liabilities	New presentation	30 December 2017 re-presented	Classification & measurement	Expected credit losses	Tax	1 January 2018 (IFRS 9)
	£m	£m	£m	£m	£m	£m	£m	£m
Assets								
Cash and balances at central banks	98,337			98,337		(1)		98,336
Trading assets		85,991		85,991				85,991
Derivatives			160,843	160,843				160,843
Settlement balances			2,517	2,517				2,517
Loans and advances to banks	30,251	(18,734)	(11,517)					
Loans to banks - amortised cost			11,517	11,517		(3)		11,514
Loans and advances to customers	349,919	(39,747)	(310,172)					
Loans to customers - amortised cost			310,116	310,116	(2,191)	(524)		307,401
Debt securities	78,933	(27,481)	(51,452)					
Equity shares	450	(29)	(421)					

Other financial assets			51,929	51,929	2,752	(3)		54,678
Settlement balances	2,517		(2,517)					
Derivatives	160,843		(160,843)					
Intangible assets	6,543			6,543				6,543
Property, plant and equipment	4,602		(4,602)					
Deferred tax	1,740		(1,740)					
Assets of disposal groups	195		(195)					
Other assets	3,726		6,537	10,263			25	10,288
Total assets	738,056			738,056	561	(531)	25	738,111
Liabilities								
Deposits by banks	46,898	(16,502)	(30,396)					
Bank deposits			30,396	30,396				30,396
Customer accounts	398,036	(36,720)	(361,316)					
Customer deposits			361,316	361,316				361,316
Debt securities in issue	30,559	(233)	(30,326)					
Settlement balances	2,844			2,844				2,844
Trading liabilities		81,982		81,982				81,982
Short positions	28,527	(28,527)						
Derivatives	154,506			154,506				154,506
Other financial liabilities			30,326	30,326				30,326
Subordinated liabilities	12,722			12,722				12,722
Other liabilities	14,871			14,871		85	41	14,997
Total liabilities	688,963			688,963		85	41	689,089
Total equity	49,093			49,093	561	(616)	(16)	49,022
Total liabilities and equity	738,056			738,056	561	(531)	25	738,111

Notes on the consolidated accounts

33 Adoption of IFRS 9 continued

The table below reflects the impact of IFRS 9 on total equity:

	Total
	£m
At 31 December 2017 - under IAS 39	49,093
Classification & measurement	561
- Mandatory fair value through profit or loss assets - adjustments following business model reviews (SPPI) (1)	579
- Equity shares held at cost under IAS 39 - fair value adjustments through FVOCI reserve	48
- Additional write-down of amortised cost assets	(66)
Expected credit losses	(616)
- Amortised cost assets	(531)
- Contingent liabilities and commitments	(85)
Tax	(16)
At 1 January 2018 - under IFRS on transition to IFRS 9	49,022

Note:

(1) Includes £583 million credit in relation to loans to customers and £4 million debit in relation to debt securities.

34 Related parties

UK Government

On 1 December 2008, the UK Government through HM Treasury became the ultimate controlling party of The Royal Bank of Scotland Group plc. The UK Government s shareholding is managed by UK Government Investments Limited, a company wholly owned by the UK Government. As a result, the UK Government and UK Government controlled bodies became related parties of the Group.

The Group enters into transactions with many of these bodies on an arm s length basis. Transactions include the payment of: taxes principally UK corporation tax (Note 7) and value added tax; national insurance contributions; local authority rates; and regulatory fees and levies (including the bank levy (Note 3) and FSCS levies (Note 27) together with banking transactions such as loans and deposits undertaken in the normal course of banker-customer relationships.

Bank of England facilities

The Group may participate in a number of schemes operated by the Bank of England in the normal course of business.

Members of the Group that are UK authorised institutions are required to maintain non-interest bearing (cash ratio) deposits with the Bank of England amounting to 0.296% of their average eligible liabilities in excess of £600 million. They also have access to Bank of England reserve accounts: sterling current accounts that earn interest at the Bank of England Rate.

Other related parties

(a) In their roles as providers of finance, RBS companies provide development and other types of capital support to businesses. These investments are made in the normal course of business and on arm s length terms. In some instances, the investment may extend to ownership or control over 20% or more of the voting rights of the investee company. However, these investments are not considered to give rise to transactions of a materiality requiring disclosure under IAS 24.

(b) RBS recharges The Royal Bank of Scotland Group Pension Fund with the cost of administration services incurred by it. The amounts involved are not material to the Group.

(c) In accordance with IAS 24, transactions or balances between RBS entities that have been eliminated on consolidation are not reported.

(d) The captions in the primary financial statements of the parent company include amounts attributable to subsidiaries. These amounts have been disclosed in aggregate in the relevant notes to the financial statements.

35 Post balance sheet events

On 6 February 2019, a General Meeting of shareholders authorised the directors to agree buy-backs by the company of ordinary shares from HM Treasury. The authority is subject to renewal at the company s forthcoming Annual General Meeting.

Other than this there have been no other significant events between 31 December 2018 and the date of approval of these accounts which would require a change to or additional disclosure in the accounts.

Notes on the consolidated accounts

36 Consolidating financial information

NatWest Markets Plc (NWM Plc) (formerly RBS plc, renamed in 2018) is a wholly owned subsidiary of The Royal Bank of Scotland Group plc (RBSG plc) and was able to offer and sell certain securities in the US from time to time pursuant to a registration statement on Form F-3 filed with the SEC with a full and unconditional guarantee from RBSG plc.

NWM Plc utilises an exception provided in Rule 3-10 of Regulation S-X, and therefore does not file its financial statements with the SEC. In accordance with the requirements to qualify for the exception, presented below is condensed consolidating financial information for:

- RBSG plc on a stand-alone basis as guarantor;
- NWM Plc on a stand-alone basis as issuer;
- Non-guarantor Subsidiaries of RBSG plc and NWM Plc on a combined basis (Subsidiaries);
- Consolidation adjustments; and
- RBSG plc consolidated amounts (RBS Group).

Under IAS 27, RBSG plc and NWM Plc account for investments in their subsidiary undertakings at cost less impairment. Rule 3-10 of Regulation S-X requires a company to account for its investments in subsidiary undertakings using the equity method, which would decrease the results for the period of RBSG plc and increase the results for the period of NWM Plc in the information below by £811 million and £1,546 million respectively for the year ended 31 December 2018 (increase by £92 million and £934 million respectively for the year ended 31 December 2017; increase by £142 million and decrease by £1,316 million respectively for the year ended 31 December 2016).

The net assets of RBSG plc would be decreased and NWM Plc increased in the information below by £8,651 million and £165 million respectively at 31 December 2018 (decreased £6,631 million and £9,319 million respectively at 31 December 2017).

NWM Plc Disposal groups and discontinued operations

NatWest Holdings Limited (NatWest Holdings)

The transfer of the NWM Plc UK Personal Banking (UK PB), Ulster Bank RoI, Commercial & Private Banking (CPB) and certain parts of Central items and NatWest Markets, included in the ring-fenced bank, to subsidiaries of NatWest Holdings, was completed in 2018. It was followed by the transfer of NatWest Holdings to RBSG plc. Accordingly, all of the NWM Plc activities now undertaken by NatWest Holdings and its subsidiaries were classified as disposal groups in the NWM Plc accounts at 31 December 2017 and presented as discontinued operations until business transferred in 2018, with comparatives re-presented.

Notes on the consolidated accounts

36 Consolidating financial information continued

Income statement

For the year ended 31 December 2018	RBSG plc £m	NWM Plc £m	Subsidiaries £m	Consolidation adjustments £m	RBS Group £m
Net interest income	(368)	(239)	8,028	1,235	8,656
Non-interest income	2,794	1,002	3,740	(2,790)	4,746
Total income	2,426	763	11,768	(1,555)	13,402
Operating expenses	(85)	(1,262)	(6,855)	(1,443)	(9,645)
Impairment releases/(losses)	1	89	(429)	(59)	(398)
Operating profit/(loss) before tax	2,342	(410)	4,484	(3,057)	3,359
Tax	149	51	(1,322)	(86)	(1,208)
Profit/(loss) from continuing operations	2,491	(359)	3,162	(3,143)	2,151
Profit/(loss) from discontinued operations, net of tax		54		(54)	
Profit/(loss) for the year	2,491	(305)	3,162	(3,197)	2,151
Attributable to:					
Non-controlling interests			(38)	30	(8)
Preference shareholders	182				182
Paid-in equity holders	355				355
Ordinary shareholders	1,954	(305)	3,200	(3,227)	1,622
	2,491	(305)	3,162	(3,197)	2,151

Statement of comprehensive income

For the year ended 31 December 2018	RBSG plc £m	NWM Plc £m	Subsidiaries £m	Consolidation adjustments £m	RBS Group £m
Profit/(loss) for the year	2,491	(305)	3,162	(3,197)	2,151
Items that do not qualify for reclassification					
Remeasurement of retirement benefit schemes					
- contributions in preparation for ring-fencing (1)		(53)	(2,000)		(2,053)
- other movements		(9)	95		86
Profit on fair value of credit in financial liabilities designated at fair value through profit or loss due to own credit risk		121	79		200
Fair value through other comprehensive income (FVOCI) financial assets		22	28	(2)	48
Tax		(24)	526		502
		57	(1,272)	(2)	(1,217)
Items that do qualify for reclassification					
Fair value through other comprehensive income (FVOCI) financial assets		(339)	808	(462)	7

Cash flow hedges	78	223	(550)	(332)	(581)
Currency translation		168	(2,488)	2,630	310
Tax	(15)	36	40	128	189
	63	88	(2,190)	1,964	(75)
Other comprehensive income/(loss) after tax	63	145	(3,462)	1,962	(1,292)
Total comprehensive income/(loss) for the year	2,554	(160)	(300)	(1,235)	859
Total comprehensive income/(loss) is attributable to:					
Non-controlling interests			(103)	120	17
Preference shareholders	182				182
Paid-in equity holders	355				355
Ordinary shareholders	2,017	(160)	(197)	(1,355)	305
	2,554	(160)	(300)	(1,235)	859

Note:

(1) On 17 April 2018 RBS agreed a Memorandum of Understanding (MoU) with the Trustees of the RBS Group Pension Fund in connection with the requirements of ring-fencing. NatWest Markets Plc cannot continue to be a participant in the Main section and separate arrangements are required for its employees. Under the MoU NatWest Bank made a contribution of £2 billion on 9 October 2018 to strengthen funding of the Main section in recognition of the changes in convenant. Also under the MoU, NatWest Markets Plc is required to make a £53 million contribution to the NWM section in Q1 2019.

Notes on the consolidated accounts

36 Consolidating financial information continued

Income statement

For the year ended 31 December 2017	RBSG plc £m	NWM Plc £m	Subsidiaries £m	Consolidation adjustments £m	RBS Group £m
Net interest income	203	(26)	6,157	2,653	8,987
Non-interest income	1,390	909	(674)	2,521	4,146
Total income	1,593	883	5,483	5,174	13,133
Operating expenses	(122)	(1,601)	(3,946)	(4,732)	(10,401)
Impairment releases/(losses)		77	(370)	(200)	(493)
Operating profit/(loss) before tax	1,471	(641)	1,167	242	2,239
Tax	(94)	168	(853)	48	(731)
Profit/(loss) from continuing operations	1,377	(473)	314	290	1,508
(Loss)/profit from discontinued operations, net of tax		(510)		510	
Profit/(loss) for the year	1,377	(983)	314	800	1,508
Attributable to:					
Non-controlling interests			5	30	35
Preference shareholders	234				234
Paid-in equity holders	483			4	487
Ordinary shareholders	660	(983)	309	766	752
	1,377	(983)	314	800	1,508

Statement of comprehensive income

For the year ended 31 December 2017	RBSG plc £m	NWM Plc £m	Subsidiaries £m	Consolidation adjustments £m	RBS Group £m
Profit/(loss)for the year	1,377	(983)	314	800	1,508
Items that do not qualify for reclassification					
Profit on remeasurement of retirement benefit schemes		4	86		90
Loss on fair value of credit in financial liabilities designated at fair value through profit or loss due to own credit risk		(68)	(58)		(126)
Tax		(18)	8		(10)
		(82)	36		(46)
Items that do qualify for reclassification					
Available-for-sale financial assets		52	(341)	315	26
Cash flow hedges	(204)	(424)	(24)	(417)	(1,069)
Currency translation		(22)	495	(373)	100
Tax	38	93	20	105	256
	(166)	(301)	150	(370)	(687)
Other comprehensive (loss)/income after tax	(166)	(383)	186	(370)	(733)

Total comprehensive income/(loss) for the year	1,211	(1,366)	500	430	775
Total comprehensive income/(loss) is attributable to:					
Non-controlling interests				52	52
Preference shareholders	234				234
Paid-in equity holders	483			4	487
Ordinary shareholders	494	(1,366)	500	374	2
	1,211	(1,366)	500	430	775

Notes on the consolidated accounts

36 Consolidating financial information continued

Income statement

For the year ended 31 December 2016	RBSG plc £m	NWM Plc £m	Subsidiaries £m	Consolidation adjustments £m	RBS Group £m
Net interest income	267	4	6,050	2,387	8,708
Non-interest income	(4,945)	1,066	(5,099)	12,860	3,882
Total income	(4,678)	1,070	951	15,247	12,590
Operating expenses	(738)	(3,864)	(5,911)	(5,681)	(16,194)
Impairment releases/(losses)		73	(4)	(547)	(478)
Operating (loss)/profit before tax	(5,416)	(2,721)	(4,964)	9,019	(4,082)
Tax	66	(199)	(827)	(147)	(1,107)
(Loss)/profit from continuing operations	(5,350)	(2,920)	(5,791)	8,872	(5,189)
(Loss)/profit from discontinued operations, net of tax		(531)		531	
(Loss)/profit for the year	(5,350)	(3,451)	(5,791)	9,403	(5,189)
Attributable to:					
Non-controlling interests			5	5	10
Preference shareholders	260	23		(23)	260
Paid-in equity holders	294			9	303
Dividend access share	1,193				1,193
Ordinary shareholders	(7,097)	(3,474)	(5,796)	9,412	(6,955)
	(5,350)	(3,451)	(5,791)	9,403	(5,189)

Statement of comprehensive income

For the year ended 31 December 2016	RBSG plc £m	NWM Plc £m	Subsidiaries £m	Consolidation adjustments £m	RBS Group £m
(Loss)/profit for the year	(5,350)	(3,451)	(5,791)	9,403	(5,189)
Items that do not qualify for reclassification					
Profit/(loss) on remeasurement of retirement benefit schemes		63	(1,112)		(1,049)
Tax		(21)	309		288
		42	(803)		(761)
Items that do qualify for reclassification					
Available-for-sale financial assets		(61)	293	(326)	(94)
Cash flow hedges	189	(40)	1	615	765
Currency translation		(90)	709	644	1,263
Tax	(35)	28	50	(149)	(106)
	154	(163)	1,053	784	1,828
Other comprehensive income/(loss) after tax	154	(121)	250	784	1,067
Total comprehensive (loss)/income for the year	(5,196)	(3,572)	(5,541)	10,187	(4,122)

Total comprehensive (loss)/income is attributable to:					
Non-controlling interests			87	34	121
Preference shareholders	260	23		(23)	260
Paid-in equity holders	294			9	303
Dividend access share	1,193				1,193
Ordinary shareholders	(6,943)	(3,595)	(5,628)	10,167	(5,999)
	(5,196)	(3,572)	(5,541)	10,187	(4,122)

Notes on the consolidated accounts

36 Consolidating financial information continued

Balance sheet

At 31 December 2018	RBSG plc £m	NWM Plc £m	Subsidiaries £m	Consolidation adjustments £m	RBS Group £m
Assets					
Cash and balances at central banks		11,095	77,802		88,897
Trading assets		61,990	13,228	(99)	75,119
Derivatives	543	134,291	3,710	(5,195)	133,349
Settlement balances		1,421	1,507		2,928
Loans to banks - amortised cost		454	12,527	(34)	12,947
Loans to customers - amortised cost		7,908	297,200	(19)	305,089
Amount due from holding company and fellow subsidiaries	22,791	11,800	70,638	(105,229)	
Other financial assets	241	10,995	48,481	(232)	59,485
Intangible assets			6,314	302	6,616
Other assets	56,773	2,087	10,968	(60,023)	9,805
Total assets	80,348	242,041	542,375	(170,529)	694,235
Liabilities					
Bank deposits		2,777	20,596	(76)	23,297
Customer deposits		2,390	358,531	(7)	360,914
Amount due to holding company and fellow subsidiaries	635	23,505	80,933	(105,073)	
Settlement balances		1,977	1,089		3,066
Trading liabilities		54,540	17,909	(99)	72,350
Derivatives	445	129,974	3,655	(5,177)	128,897
Other financial liabilities	16,821	16,279	6,625	7	39,732
Subordinated liabilities	7,941	659	2,058	(123)	10,535
Other liabilities	119	1,018	8,552	(735)	8,954
Total liabilities	25,961	233,119	499,948	(111,283)	647,745
Owners equity	54,387	8,922	42,416	(59,989)	45,736
Non-controlling interests			11	743	754
Total equity	54,387	8,922	42,427	(59,246)	46,490
Total liabilities and equity	80,348	242,041	542,375	(170,529)	694,235

Notes on the consolidated accounts

36 Consolidating financial information continued

Balance sheet

At 31 December 2017	RBSG plc £m	NWM Plc £m	Subsidiaries £m	Consolidation adjustments £m	RBS Group £m
Assets					
Cash and balances at central banks		93	36,707	61,537	98,337
Trading assets		73,011	13,051	(71)	85,991
Derivatives	163	162,005	3,101	(4,426)	160,843
Settlement balances		1,614	899	4	2,517
Loans to banks - amortised cost		195	5,181	6,141	11,517
Loans to customers - amortised cost		9,133	223,755	77,228	310,116
Amounts due from holding company and fellow subsidiaries	24,987	6,470	14,352	(45,809)	
Other financial assets	107	3,079	4,350	44,393	51,929
Intangible assets			531	6,012	6,543
Other assets	47,605	270,289	(33,032)	(274,599)	10,263
Total assets	72,862	525,889	268,895	(129,590)	738,056
Liabilities					
Bank deposits		527	22,367	7,502	30,396
Customer deposits		3,063	274,847	83,406	361,316
Amounts due to holding company and fellow subsidiaries	163	14,994	30,652	(45,809)	
Settlement balances		1,372	1,472		2,844
Trading liabilities		64,182	17,913	(113)	81,982
Derivatives	284	155,098	3,289	(4,165)	154,506
Other financial liabilities	9,202	11,255	1,243	8,626	30,326
Subordinated liabilities	7,864		2,197	2,661	12,722
Other liabilities	388	230,876	(110,598)	(105,795)	14,871
Total liabilities	17,901	481,367	243,382	(53,687)	688,963
Owners equity	54,961	44,522	25,382	(76,535)	48,330
Non-controlling interests			131	632	763
Total equity	54,961	44,522	25,513	(75,903)	49,093
Total liabilities and equity	72,862	525,889	268,895	(129,590)	738,056

Notes on the consolidated accounts

36 Consolidating financial information continued

Cash flow statement

For the year ended 31 December 2018	RBSG plc £m	NWM Plc £m	Subsidiaries £m	Consolidation adjustments £m	RBS Group £m
Net cash flows from operating activities	13,711	(1,308)	(81,109)	68,478	(228)
Net cash flows from investing activities	(9,481)	18,288	(32,446)	15,684	(7,955)
Net cash flows from financing activities	(4,169)	(5,795)	7,988	(4,311)	(6,287)
Effects of exchange rate changes on cash and cash equivalents	1	332	565	(222)	676
Net increase/(decrease) in cash and cash equivalents	62	11,517	(105,002)	79,629	(13,794)
Cash and cash equivalents at 1 January 2018	245	13,058	196,214	(86,912)	122,605
Cash and cash equivalents at 31 December 2018	307	24,575	91,212	(7,283)	108,811

For the year ended 31 December 2017	RBSG plc £m	NWM Plc £m	Subsidiaries £m	Consolidation adjustments £m	RBS Group £m
Net cash flows from operating activities	4,973	(74,357)	105,401	2,724	38,741
Net cash flows from investing activities	(2,078)	(2,077)	1,911	(4,238)	(6,482)
Net cash flows from financing activities	(3,831)	(9,668)	573	4,718	(8,208)
Effects of exchange rate changes on cash and cash equivalents	(14)	87	(1,102)	1,013	(16)
Net (decrease)/increase in cash and cash equivalents	(950)	(86,015)	106,783	4,217	24,035
Cash and cash equivalents at 1 January 2017	1,195	99,073	89,431	(91,129)	98,570
Cash and cash equivalents at 31 December 2017	245	13,058	196,214	(86,912)	122,605

For the year ended 31 December 2016	RBSG plc £m	NWM Plc £m	Subsidiaries £m	Consolidation adjustments £m	RBS Group £m
Net cash flows from operating activities	(3,026)	3,098	(6,823)	3,101	(3,650)
Net cash flows from investing activities	2,538	(4,495)	(1,919)	(483)	(4,359)
Net cash flows from financing activities	(1,445)	(13,459)	(1,490)	11,287	(5,107)
Effects of exchange rate changes on cash and cash equivalents	122	7,316	4,260	(3,604)	8,094
Net (decrease)/increase in cash and cash equivalents	(1,811)	(7,540)	(5,972)	10,301	(5,022)
Cash and cash equivalents at 1 January 2016	3,006	106,613	95,403	(101,430)	103,592
Cash and cash equivalents at 31 December 2016	1,195	99,073	89,431	(91,129)	98,570

Trust preferred securities

The Group has issued trust preferred securities through trusts 100% owned by the Group (through partnership interests held by RBSG Capital Corporation and RBS) which meet the definition of a finance subsidiary in Regulation S-X, Rule 3-10. The securities represent undivided beneficial interests in the assets of the trusts, which consist of partnership preferred securities representing non-cumulative perpetual preferred limited partnership interests issued by Delaware limited partnerships. The Royal Bank of Scotland Group plc has provided subordinated guarantees for the benefit of the holders of the trust preferred securities and the partnership preferred securities. Under the terms of the guarantees, the Group has fully and unconditionally guaranteed on a subordinated basis, payments on such trust preferred securities and partnership preferred securities, to the extent they are due to be paid and have not been paid by, or on behalf of, the trusts and the partnerships, as the case may be. Following implementation of IFRS 10 the trusts are no longer consolidated by the Group. For those securities that were classified as subordinated liabilities, the Group s outstanding instruments with the trusts are classified as subordinated liabilities.

EXHIBIT INDEX

Exhibit No.	Description
99.1	Consent of independent registered public accounting firm (Ernst & Young LLP)
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Scheme
101.CAL	XBRL Taxonomy Extension Scheme Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Scheme Definition Linkbase
101.LAB	XBRL Taxonomy Extension Scheme Label Linkbase
101.PRE	XBRL Taxonomy Extension Scheme Presentation Linkbase

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorised

The Royal Bank of Scotland Group plc

Registrant

/s/ Katie Murray

Katie Murray

Chief Financial Officer

30 April 2019