RBS Holdings N.V.
Form 20-F
April 30, 2015

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

FORM 20-F

(Mark One)

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

OR

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

For the fiscal year ended December 31, 2014

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

OR

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

Commission file number: 1-14624

RBS Holdings N.V.
(Exact name of Registrant as specified in its charter)

The Netherlands
(Jurisdiction of incorporation)

Gustav Mahlerlaan 10, 1082 PP Amsterdam, The Netherlands
(Address of principal executive offices)

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

Title of each class	Name of each exchange on which registered
Guarantee of 5.90% Non-cumulative Guaranteed Trust Preferred Securities of RBS Capital Funding Trust V	New York Stock Exchange*
Guarantee of 6.25% Non-cumulative Guaranteed Trust Preferred Securities of RBS Capital Funding Trust VI	New York Stock Exchange**
Guarantee of 6.08% Non-cumulative Guaranteed Trust Preferred Securities of RBS Capital Funding Trust VII	New York Stock Exchange***
5.90% Non-cumulative Guaranteed Trust Preferred Securities of RBS Capital Funding Trust V	New York Stock Exchange
6.25% Non-cumulative Guaranteed Trust Preferred Securities of RBS Capital Funding Trust VI	New York Stock Exchange
6.08% Non-cumulative Guaranteed Trust Preferred Securities of RBS Capital Funding Trust VII	New York Stock Exchange
4.65% Subordinated Notes due 2018	Euronext Amsterdam

* The guarantee is not listed for trading, but is listed only in connection with the registration of the corresponding Non-cumulative Guaranteed Trust Preferred Securities of RBS Capital Funding Trust V.
** The guarantee is not listed for trading, but is listed only in connection with the registration of the corresponding Non-cumulative Guaranteed Trust Preferred Securities of RBS Capital Funding Trust VI.
*** The guarantee is not listed for trading, but is listed only in connection with the registration of the corresponding Non-cumulative Guaranteed Trust Preferred Securities of RBS Capital Funding Trust VII.

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

None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

Indicate the number of outstanding shares of each class of common stock of the close of the period covered by the annual report

(Title of each class)	(Number of outstanding shares)
Ordinary shares, par value €0.56 per share	89,287

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

o Yes x No

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

o Yes x No

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

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

x Yes o No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

o Yes o No

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

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

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

o U.S. GAAP
x International Financial Reporting Standards as issued by the International Accounting Standards Board
o Other

If “Other” has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

o Item 17 o Item 18

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

o Yes x No

Annual report and accounts

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Chairman's statement

On 19 April 2011 it was announced that a substantial part of the business activities of RBS N.V. would transfer to RBS plc. The majority of the transfers were concluded in 2011 and 2012. A few businesses remain, including India, Indonesia and China, and their future is being considered in light of the recently announced changes to our wholesale banking proposition. As confirmed on 19 April 2011, the RBS Group is committed to provide the necessary support to ensure that RBS N.V. continues to meet its commitments during and after the transfer of businesses to RBS plc. During 2014, the activities of the RBSH Group in Thailand transferred to RBS plc in addition to other separate assets and liabilities.

A major milestone we reached last year was the completion of the Asset Quality Review as mandated by the European Central Bank (ECB). As the RBS Holdings (RBSH) Group was designated as a significant institution, a detailed review of the RBSH Group's balance sheet took place. We were pleased with the outcome as no major items were raised. Subsequently, on 4 November the ECB formally took over the role of lead supervisor of the RBSH Group from the Dutch Central Bank (DNB). The DNB continues to be part of the Joint Supervisory Team headed by the ECB.

In February 2015, RBS Group announced changes to its Corporate & Institutional Banking (CIB) business to build a stronger, safer and more sustainable business, focused mainly on UK and Western European customers, both corporates and financial institutions, supported by trading and distribution platforms in the UK, US and Singapore. As a consequence, RBS Group will reduce its geographical footprint to approximately 13 countries, compared with 38 at the end of 2014.

As announced, we are exploring the option of a sale for the countries that are to be exited. If this is not feasible, it is expected that the countries will be wound down. The full impact of the announced changes on RBS N.V. is currently being reviewed.

Under the new structure, the RBSH Group and its businesses moved to the new Capital Resolution organisation. For 2015, the focus will remain on the further de-risking of our balance sheet.

Results of operations in 2014

Operating loss before tax was €57 million compared with a loss of €142 million in 2013. This was largely due to lower expenses as a result of lower staff and non-staff costs, due to business transfers to RBS plc, partly offset by lower income due to the transfers of business and the loss on sale of the majority of the liquidity portfolio.

Net interest income decreased due to transfers to RBS plc and the continued low interest rate environment, while non-interest income decreased mainly due to higher losses on the sale of available-for-sale securities.

Total equity as at 31 December 2014, was €3.5 billion, an increase of €0.6 billion compared to 31 December 2013, mainly due to unrealised gains and realised losses on available-for-sale assets.

Capital

RBSH Group continues to be well capitalised. On 31 December 2014, RBSH Group's Total capital ratio was 33.9%, the Tier 1 capital ratio was 24.5% and the Core Tier 1 capital ratio was 16.2%.

Outlook

The outlook for the global economy over the near to medium-term is for modest growth. Risks to growth and stability stem mainly from continued imbalances - among and within countries - and from uncertainty about how economies will respond as the extraordinary monetary policy measures implemented during the crisis are unwound and to other measures that have just been instigated..

Against this background, commercial performance is expected to remain broadly flat.

I would like to conclude by referring to a statement recently made by RBS Group Chief Executive, Ross McEwan:

“Last year we identified the areas we needed to improve in order to deliver our strategy - cost, complexity, capital and trust from our customers. The energy and resolve of our people have resulted in significant progress on each, and we have delivered on the goals we set for 2014.”

On behalf of the RBS N.V. Managing Board, I would like to thank all our employees and clients for their continued commitment during 2014.

Jan de Ruiter
Chairman of the Managing Board RBS Holdings N.V.

Amsterdam, 30 April 2015

Report and accounts Financial review

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Presentation of information

In this document and unless specified otherwise, the terms 'company' and 'RBS Holdings' mean RBS Holdings N.V.. RBS Holdings N.V. is the parent company of The Royal Bank of Scotland N.V. (RBS N.V.) consolidated group of companies and associated companies (RBSH Group). The Royal Bank of Scotland Group plc (RBSG) is the ultimate holding company of RBSH Group. RBS Group refers to RBSG and its consolidated subsidiaries and associated companies. RBS plc refers to The Royal Bank of Scotland plc. The terms 'Consortium' and 'Consortium Members' refer to RBSG, Stichting Administratiekantoor Beheer Financiële Instellingen (the Dutch State, successor to Fortis) and Banco Santander S.A. (Santander) who jointly acquired RBS Holdings on 17 October 2007 through RFS Holdings B.V. (RFS Holdings).

The company publishes its financial statements in 'euro', the European single currency. The abbreviations '€m' and '€bn' represent millions and thousands of millions of euros, respectively. Reference to '$' is to United States of America (US) dollars. The abbreviations '$m' and '$bn' represent millions and thousands of millions of dollars, respectively.

Certain information in this report is presented separately for domestic and foreign activities. Domestic activities consist of transactions within the Netherlands. Geographic analysis has been compiled on the basis of location of office.

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

All annual averages in this report are based on month-end figures. Management does not believe that these month-end averages present trends materially different from those that would be presented by daily averages.

International Financial Reporting Standards

Unless otherwise indicated, the financial information contained in this Annual Report has been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) and IFRS as issued by the International Accounting Standard Board (IASB).

Revised organisational structure

During 2014, the RBS Group introduced a new organisational structure - see page 8 for details. Segmental data for RBSH Group for prior years have been restated accordingly.

Glossary

A glossary of terms is included on pages 195 to 201.

Forward-looking statements

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

In particular, this document includes forward-looking statements relating, but not limited to: the impact of certain aspects of the transformation plan announced by the RBS Group on RBSH Group, the impact of the restructuring of the RBS Group’s CIB business on the remaining transfers of certain of the businesses of RBSH Group to RBS plc (the “Transfers), the impact on RBSH Group of the implementation of the ring-fence of the retail banking operations of RBS Group, divestments, capitalisation, portfolios, net interest margin, capital and leverage ratios, liquidity, risk-weighted assets (RWAs), RWA equivalents (RWAe), Maximum Distributable Amounts (MDA), minimum requirements for eligible liabilities (MREL), return on equity (ROE), profitability, cost:income ratios, loan:deposit ratios, funding and risk profile; discretionary coupon and dividend payments; litigation, regulatory and governmental investigations; RBSH Group’s future financial performance; the level and extent of future impairments and write-downs; and RBSH Group’s exposure to credit rating risk and to various types of market risks, such as interest rate risk, foreign exchange rate risk and commodity and equity price risk. These statements are based on current plans, estimates and projections, and are subject to inherent risks, uncertainties and other factors which could cause actual results to differ materially from the future results expressed or implied by such forward-looking statements. For example, certain market risk disclosures are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market risk disclosures are only estimates and, as a result, actual future gains and losses could differ materially from those that have been estimated.

Other factors that could adversely affect RBSH Group’s results and the accuracy of forward-looking statements in this document include the risk factors and other uncertainties discussed on pages 181 to 192. These include: RBSH Group’s reliance on the RBS Group, RBSH Group’s ability to achieve its capital targets, RBSH Group’s ability to attract and retain qualified personnel; uncertainties regarding the outcomes of legal, regulatory and governmental actions and investigations that RBS Group and RBSH Group are subject to and any resulting material adverse effect on RBSH Group of unfavourable outcomes; heightened regulatory and governmental scrutiny and the increasingly regulated environment in which RBSH Group operates; operational risks that are inherent in RBSH Group’s business; the potential negative impact on RBSH Group’s business of actual or perceived global economic and financial market conditions and other global risks; uncertainties regarding RBSH Group’s exposure to any weakening of economies within the EU and renewed threat of default by certain counties in the Eurozone; the achievement of capital and costs reduction targets; ineffective management of capital or changes to regulatory requirements relating to capital adequacy and liquidity; the ability to access sufficient sources of capital, liquidity and funding when required; deteriorations in borrower and counterparty credit quality; the extent of future write-downs and impairment charges caused by depressed asset valuations; the impact of unanticipated turbulence in interest rates, yield curves, foreign currency exchange rates, credit spreads, bond prices, commodity prices, equity prices; basis, volatility and correlation risks; changes in the credit ratings of RBSG, the Bank or other entities of the RBS Group; changes to the valuation of financial instruments recorded at fair value; competition and consolidation in the banking sector; regulatory or legal changes; changes to the monetary and interest rate policies of central banks and other governmental and regulatory bodies; changes in laws, regulations, accounting standards and taxes; the high dependence of RBSH Group’s operations on its information technology systems and its increasing exposure to cyber security threats; the reputational risks inherent in RBSH Group’s operations; the risk that RBSH Group may suffer losses due to employee misconduct; the recoverability of deferred tax assets by RBSH Group; liabilities resulting from the legal demerger of ABN Amro Bank N.V.; and the success of RBSH Group in managing the risks involved in the foregoing.

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

The information, statements and opinions contained in this document do not constitute a public offer under any applicable legislation or an offer to sell or solicitation of any offer to buy any securities or financial instruments or any advice or recommendation with respect to such securities or other financial instruments.

Financial review

Description of business

Introduction

RBS Holdings offers a range of banking products and financial services, principally in Europe and Asia.

In 2007, RFS Holdings, which was jointly owned by RBSG, Fortis (succeeded by the Dutch State in 2008) and Santander (together, the 'Consortium Members') completed the acquisition of RBS Holdings.

RBS Holdings has one direct subsidiary, RBS N.V., a fully operational bank within RBSH Group. RBS N.V. is independently rated and regulated, effective from 4 November 2014 the Dutch Central Bank was replaced as the main regulator by the European Central Bank (ECB) in conjunction with the Dutch Central Bank. Certain assets within RBS N.V. continue to be owned by the Dutch State or shared by the Consortium Members.

Since 31 December 2010, RBSG's shareholding in RFS Holdings has been 97.72%. RFS Holdings is controlled by RBSG, which is incorporated in the UK and registered at 36 St Andrew Square, Edinburgh, Scotland. RBSG is the ultimate parent company of RBSH Group. The consolidated financial statements of RBSH Group are included in the consolidated financial statements of RBS Group.

RBSH Group had total assets of €23.6 billion and Total equity of €3.5 billion at 31 December 2014. RBSH Group’s capital ratios were a Total capital ratio of 33.9%, a Tier 1 capital ratio of 24.5% and a Common Equity Tier 1 capital ratio of 16.2% as at 31 December 2014.

Organisational structure and business review

On 27 February 2014, RBS Group announced the reorganisation of the previously reported operating divisions into three franchises: Personal & Business Banking, Commercial & Private Banking and Corporate & Institutional Banking (CIB). Only CIB, comprising the former Markets and International Banking divisions, is relevant for RBSH Group. CIB is a single reportable segment.

Corporate & Institutional Banking is the wholesale banking business comprising, Markets and Transaction Services which work closely together to serve customers. The businesses operate internationally providing lending, fixed income, foreign exchange, rates, credit, securitisation and transaction banking services primarily to large UK and international corporates and financial institutions.

Services supports the customer-facing businesses and provides operational technology, customer support in telephony, account management, lending and money transmission, global purchasing, property and other services. Services drives efficiencies and supports income growth by using a single, scalable platform and common processes wherever possible. It is the centre of excellence for managing large-scale and complex change. Services costs are allocated to the operating segments and is not deemed a reportable segment.

Central Functions comprises corporate functions, such as treasury, finance, risk management, legal, communications and human resources. Central functions manages RBSH Group's capital resources and provides services to the operating segments.

RBS Capital Resolution (RCR) became fully operational on 1 January 2014 with pool of c.£29 billion of RBS Group assets (of which approximately £1.5 billion related to RBSH Group) with particularly high long-term capital intensity, credit risk and/or potentially volatile outcomes in stressed environments. RCR brings assets under common management and increases focus on managing these assets so as to release capital.

Strategic review of CIB

On 26 February 2015, RBS Group announced that it is making further changes to improve its medium-term returns, building a stronger, safer and more sustainable business, focused mainly on UK and Western European customers, both corporates and financial institutions, supported by trading and distribution platforms in the UK, US and Singapore. These changes will create a more focused corporate and institutional bank built on existing product and service strengths. RBS Group will have a strong, client-focused product offering in sterling, US dollar and euro, including:

- Debt financing, with debt capital markets, structured finance and loans.
- Risk management in currency, rates and inflation.
- Transaction services, with UK-focused cash, payments and trade.

CIB will reduce its geographical footprint to approximately 13 countries, compared with 38 at the end of 2014, though RBS Group will also retain its back office operations in Poland and India. In addition to its main distribution and trading hubs in the UK, US and Singapore, RBS Group will remain present in a number of Western European countries with coverage teams. A small sales team will be retained in Japan. US operations will shrink, while retaining the presence required to support the US dollar needs of RBS Group’s UK and Western European customers. Priority client sectors will be targeted in infrastructure, transportation, financial institutions, energy and resources.

CIB will continue to reduce its balance sheet and risk profile. RWAs will be reduced by 60% by 2019, with a reduction of more than £25 billion targeted in 2015. Third party assets will be reduced by more than 60% by 2019.

This CIB strategy leaves RBS Group well-placed to meet the ring-fencing requirements of the Banking Reform Act 2013. As previously indicated, RBS Group intends to place most banking services inside the ring fence. CIB's remaining "Markets" activities, the operations of RBS International and some corporate banking activity are expected to remain outside the ring-fenced bank in separate legal entities.

Transfers of a substantial part of the business activities of RBS N.V. to RBS plc
Following the announcements in April 2011 by the Boards of RBSG, RBS plc, RBS Holdings and RBS N.V., a substantial part of the business activities of RBS N.V. had been successfully transferred to RBS plc by the end of 2012.

In 2013, assets and liabilities relating to businesses in Russia, Romania, Korea and North America were transferred to RBS plc by a combination of local schemes of arrangement, cross-border merger, novations and subsidiary share sales.

During 2014, the Thailand business was transferred to RBS plc.

RBS N.V. US branches
The RBS N.V. US branches will be closed once the remaining tail assets have been transferred and applicable regulatory approval has been received.

Competition
RBSH Group faces strong competition in all the markets it serves. Banks' balance sheets have strengthened whilst loan demand has been subdued as corporate investment levels remain low and economic growth is fragile.

Competition for corporate and institutional customers in the Netherlands and abroad is from Dutch banks and from foreign banks that offer investment and corporate banking services. In addition, RBSH Group's Corporate and Institutional Banking (CIB) business faces competition from dedicated investment banks and from non-bank institutions via disintermediation in credit and financing products. In European, American and Asian corporate and institutional banking markets RBSH Group also competes with the large domestic banks active in these markets and with the major international banks.

Financial review

Risk factors

Set out below is a summary of certain risks which could affect RBSH Group. RBSH Group is a subsidiary of RBSG and accordingly, risk factors which relate to RBSG and the RBS Group will also be of relevance. This summary should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties. A fuller description of these and other risk factors is included on pages 181 to 192.

- RBSH Group is reliant on the RBS Group as it receives capital, liquidity and funding support from the RBS Group and its banking operations function on the RBS Group's integrated global infrastructure, and such reliance will increase as RBSH Group continues to divest a number of its businesses and portfolios.

- The RBS Group's restructuring of its CIB business will impact RBSH Group as well as the planned transfers or sale of a substantial part of the business activities of RBS N.V. and the execution and/or delay in the execution or non-completion of the approved transfers or sale of such business activities may have a material adverse effect on RBSH Group. There is no assurance that RBSH Group will be able to sell and/or run-down the remaining businesses they are seeking to exit or sell asset portfolios either on favourable economic terms to RBSH Group or at all, and RBSH Group will remain exposed to prevailing market conditions as well as risks relating to liabilities, obligations and/or indemnities arising in connection with such sales or transfers.

- Operational risks are inherent in RBSH Group's businesses and these risks will increase as a result of the restructuring of the RBS Group's CIB business. RBSH Group's operations are also highly dependent on its information technology systems and RBSH Group is exposed to the risk of cyber-attacks and other cyber security threats.

- The RBS Group has started implementing the ring-fence of its retail banking operations in the UK which must be in place by 2019, and which may impact RBSH Group if the remaining disposals of its business are not completed by that date.

- RBS Group and RBSH Group are subject to a number of legal, regulatory and governmental actions and investigations. Unfavourable outcomes in such actions and investigations could have a material adverse effect on RBSH Group's operating results, investor confidence or reputation. It is expected that the RBS Group and RBSH Group will continue to have a material exposure to litigation and governmental and regulatory proceedings and investigations in the medium term.

- RBSH Group may be unable to attract or retain senior management (including members of the supervisory board) and other skilled personnel of the appropriate qualification and competence, due to RBS Group's changing strategy, including the restructuring of the RBS Group's CIB business as well as the imposition of restrictions on compensation or other regulatory initiatives. RBSH Group may suffer if it does not maintain good employee relations or as a result of employee misconduct.

- RBSH Group operates in markets that are highly competitive and subject to rapid change. Recent regulatory and legal changes are likely to result in new market participants and changed competitive dynamics in certain key areas and other competitors may have more efficient operations as well as access to lower cost/funding and better client and employee retention rates.

- RBSH Group's businesses and performance can be negatively affected by actual or perceived global economic and financial market conditions and other global risks. RBSH Group is also exposed to any weakening of the European economy and the renewed threat of default by certain countries in the Eurozone.

- RBSH Group's business performance could be adversely affected if its or the RBS Group's capital are not managed effectively or as a result of changes to capital adequacy and liquidity requirements. In addition, RBSH Group's ability to meet its obligations including its funding commitments depends on RBSH Group's ability to access sources of liquidity and funding which may be affected by credit markets and the monetary policies of central banks.

- RBSH Group's borrowing costs, its access to the debt capital markets and its liquidity depend significantly on its and the RBS Group's credit ratings. Any further reductions in the long-term or short-term credit ratings of RBS Holdings, RBS N.V., RBSG, RBS plc or one of their subsidiaries would increase borrowing costs and may limit RBSH Group's access to capital and money markets and trigger additional collateral or other requirements as well as limit the range of counterparties willing to enter into transactions with RBS Holdings and may adversely affect RBSH Group's competitive position.

- RBSH Group's businesses are subject to substantial regulation and oversight. Significant regulatory developments and increased scrutiny by RBSH Group's key regulators has increased compliance risks and has had and is likely to continue to have a material adverse effect on how RBSH Group conducts its business and on its results of operations and financial condition. The RBS Group is also subject to resolution procedures under resolution and recovery schemes which may result in various actions being taken in relation to the RBS Group and any securities of the RBS Group and which may adversely affect RBSH Group.

- The financial performance of RBSH Group has been, and may continue to be, materially affected by deteriorations in borrower and counterparty credit quality and further deteriorations could arise due to prevailing economic and market conditions and legal and regulatory developments. Depressed asset valuations resulting from poor market conditions may also result in further impairment charges and write-downs of RBSH Group's assets. In addition, changes in interest rates, foreign exchange rates, credit spreads, bond, equity and commodity prices, basis, volatility and correlation risks and other market factors have significantly affected and will continue to affect RBSH Group's business and results of operations.

- The value of certain financial instruments recorded at fair value is determined using financial models incorporating assumptions, judgements and estimates that may change over time or may ultimately not turn out to be accurate. RBSH Group's valuation, capital and stress test models and the parameters and assumptions on which they are based rely on market data inputs and need to be constantly updated to ensure their accuracy. Failure of these models to accurately reflect changes in the environment in which RBSH Group operates or the failure to properly input any such changes could have an adverse impact on the modelled results.

- The legal demerger of ABN AMRO Bank N.V. (as it was then named) has resulted in a cross liability that changes the legal recourse available to investors.

Financial review

Key financials

for the year ended 31 December	2014 €m	2013 €m	2012 €m
Total income	273	437	708
Loss before impairment losses	(46)	(100)	(822)
Operating loss before tax	(57)	(142)	(887)

at 31 December	2014 €m	2013 €m	2012 €m
Total assets	23,551	39,808	70,954
Funded assets (1)	19,119	35,026	63,399
Loans and advances to customers	3,539	3,784	6,380
Deposits	8,112	23,094	37,103
Equity attributable to controlling interests	3,473	2,942	1,799
Capital ratios (2) - Common Equity Tier 1/Core Tier 1	16.2%	20.5%	11.7%
- Tier 1	24.5%	23.2%	13.9%
- Total	33.9%	26.1%	19.8%

Notes:
(1) Funded assets represents total assets less derivatives.
(2) 2014 on CRR transitional basis.

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Financial review

Summary consolidated income statement

	2014	2013	2012
	€m	€m	€m
Net interest income	187	238	605
Fees and commissions receivable	158	119	469
Fees and commissions payable	(16)	(49)	(198)
Other non-interest income	(56)	129	(168)
Non-interest income	86	199	103
Total income	273	437	708
Operating expenses	(319)	(537)	(1,530)
Loss before impairment losses	(46)	(100)	(822)
Impairment losses	(11)	(42)	(65)
Operating loss before tax	(57)	(142)	(887)
Tax charge	(58)	(12)	(129)
Loss from continuing operations	(115)	(154)	(1,016)
Profit from discontinued operations, net of tax	15	19	17
Loss for the year	(100)	(135)	(999)

2014 compared with 2013
Operating loss before tax was €57 million compared with a loss of €142 million in 2013. This decrease was due to lower operating expenses partially offset by lower income, reflecting the transfers of businesses to RBS plc.

Total income decreased by €164 million to €273 million. This is mainly due to lower non-interest income.

Net interest income decreased by €51 million to €187 million, mainly reflecting business transfers and the continued low interest rate environment.

Non-interest income decreased by €113 million to €86 million compared with €199 million in 2013. This included higher losses on the sale of available-for-sale securities in Treasury partially offset by higher profits from interests in associates and an increase in the value of own credit adjustments.

Operating expenses decreased by €218 million to €319 million mainly due to reductions in both staff and non-staff costs as a result of business transfers to RBS plc.

Impairment losses decreased by €31 million to €11 million driven by a smaller number of individual cases.

Tax charge for 2014 was €58 million compared with €12 million in 2013.

2013 compared with 2012
Operating loss before tax was €142 million compared with a loss of €887 million in 2012. This decrease was due to lower operating expenses partially offset by lower income.

Total income decreased by €271 million to €437 million. This is mainly due to lower net interest income.

Net interest income decreased by €367 million to €238 million, reflecting further reductions in interest income, in particular in CIB, due to further business transfers to RBS plc and the continued low interest rate environment.

Non-interest income increased by €96 million to €199 million compared with €103 million in 2012. This increase is mainly due to the €776 million lower loss on own credit adjustment resulting from the widening of credit spreads of UK banks. This was partially offset by lower net fees and commissions as a result of business transfers to RBS plc, and lower profit on sales of subsidiaries and associates and securities.

Operating expenses decreased by €993 million to €537 million due to reduced staff and non-staff costs as a result of staff transferring as part of business transfers to RBS plc and business divestments.

Impairment losses decreased by €23 million to €42 million. The 2013 charge is driven by a small number of individual cases. The reduction reflects business transfers to RBS plc.

Tax charge for 2013 was €12 million compared with €129 million in 2012. The higher rate for 2012 was mainly the result of the reduction in carrying value of the deferred tax asset in respect of losses in Australia

Financial review

Analysis of results
Net interest income

	2014	2013	2012
	€m	€m	€m
Interest receivable	532	768	1,628
Interest payable (1)	(345)	(493)	(1,023)
Net interest income	187	275	605
Yields, spreads and margins of the banking business	%	%	%
Gross yield on interest-earning assets of the banking business (2)	2.1	1.8	2.1
Cost of interest-bearing liabilities of the banking business	(1.9)	(1.3)	(1.4)
Interest spread of the banking business (3)	0.2	0.5	0.7
Benefit from interest-free funds	0.5	0.2	0.1
Net interest margin of the banking business (4)	0.7	0.7	0.8
Gross yield (2)			
- Group	2.1	1.8	2.1
- Domestic	1.3	1.1	1.4
- Foreign	3.5	3.2	2.8
Interest spread (3)			
- Group	0.2	0.5	0.7
- Domestic	(0.2)	0.4	(0.1)
- Foreign	0.4	1.0	1.6
Net interest margin (4)			
- Group	0.7	0.7	0.8
- Domestic	—	0.5	(0.2)
- Foreign	2.1	1.0	1.8

Notes:
(1) Interest payable decreased in 2013 by €37 million in respect of adjustments in 2014 (2012 nil).
(2) Gross yield is the interest rate earned on average interest-earning assets of the banking business.
(3) Interest spread is the difference between the gross yield and the interest rate paid on average interest-bearing liabilities of the banking business.
(4) Net interest margin is net interest income of the banking business as a percentage of average interest-earning assets of the banking business.
(5) The analysis into Domestic and Foreign has been compiled on the basis of location of the office in which the transaction takes place.

Financial review

Average balance sheet and related interest

		2014			2013		
		Average balance	Interest	Rate	Average balance	Interest	Rate
		€m	€m	%	€m	€m	%
Assets							
Loans and advances to banks	- Domestic	4,414	18	0.4	6,130	51	0.8
	- Foreign	3,477	30	0.9	5,755	49	0.9
Loans and advances to customers	- Domestic	422	22	5.2	1,002	32	3.2
	- Foreign	4,380	234	5.3	6,386	307	4.8
Amounts due from ultimate holding company	- Domestic	2,428	151	6.2	2,805	183	6.5
Debt securities	- Domestic	8,924	20	0.2	18,014	53	0.3
	- Foreign	1,280	57	4.5	1,876	93	5.0
Interest-earning assets	- banking business	25,325	532	2.1	41,968	768	1.8
	- trading business	912			2,021		
Interest-earning assets		26,237			43,989		
Non-interest-earning assets		6,492			17,493		
Total assets		32,729			61,482		
Percentage of assets applicable to overseas operations		41.6 %			41.0 %		
Liabilities							
Deposits by banks	- Domestic	9,056	26	0.3	20,711	117	0.6
	- Foreign	1,689	24	1.4	7,064	71	1.0
Customer accounts: demand deposits	- Foreign	597	2	0.3	2,733	11	0.4
Customer accounts: savings deposits	- Foreign	264	15	5.7	554	21	3.8
Customer accounts: other time deposits	- Domestic	402	10	2.5	547	16	2.9
	- Foreign	1,500	67	4.5	1,950	82	4.2
Debt securities in issue	- Domestic	52	1	1.9	115	4	3.5
	- Foreign	421	11	2.6	641	13	2.0
Subordinated liabilities	- Domestic	4,949	176	3.6	3,488	41	1.2
	- Foreign	99	6	6.1	2,089	125	6.0
Internal funding of trading business	- Foreign	(410)	7	(1.7)	(779)	(8)	1.0
Interest-bearing liabilities	- banking business (1)	18,619	345	1.9	39,113	493	1.3
	- trading business	2,855			2,694		
		21,474			41,807		

Interest-bearing liabilities			
Non-interest-bearing liabilities:			
Demand deposits	- Domestic	122	311
	- Foreign	443	861
Other liabilities		7,745	15,942
Owners' equity		2,945	2,561
Total liabilities and owners' equity		32,729	61,482
Percentage of liabilities applicable to overseas operations		41.6 %	40.1 %

For notes to this table refer to previous page.

Financial review

Average balance sheet and related interest continued

		2012		
		Average balance €m	Interest €m	Rate %
Assets				
Loans and advances to banks	- Domestic	7,779	59	0.8
	- Foreign	15,615	148	0.9
Loans and advances to customers	- Domestic	6,691	154	2.3
	- Foreign	16,677	711	4.3
Amounts due from ultimate holding company	- Domestic	2,091	114	5.5
Debt securities	- Domestic	24,274	272	1.1
	- Foreign	4,086	170	4.2
Interest-earning assets	- banking business	77,213	1,628	2.1
	- trading business	5,623		
Interest-earning assets		82,836		
Non-interest-earning assets		32,904		
Total assets		115,740		
Percentage of assets applicable to overseas operations		50.5 %		
Liabilities				
Deposits by banks	- Domestic	26,210	283	1.1
	- Foreign	15,613	129	0.8
Customer accounts: demand deposits	- Domestic	7,090	60	0.8
	- Foreign	12,900	66	0.5
Customer accounts: savings deposits	- Foreign	768	28	3.6
Customer accounts: other time deposits	- Domestic	1,372	44	3.2
	- Foreign	3,767	140	3.7
Debt securities in issue	- Domestic	4,258	63	1.5
	- Foreign	1,038	22	2.1
Subordinated liabilities	- Domestic	4,375	70	1.6
	- Foreign	2,776	162	5.8
Internal funding of trading business	- Foreign	(4,429)	(44)	1.0
Interest-bearing liabilities	- banking business (1)	75,738	1,023	1.4
	- trading business	11,934		
Interest-bearing liabilities		87,672		
Non-interest-bearing liabilities:				
Demand deposits	- Domestic	706		
	- Foreign	2,084		
Other liabilities		21,466		
Owners' equity		3,812		
Total liabilities and owners' equity		115,740		
Percentage of liabilities applicable to overseas operations		54.9 %		

For notes to this table refer to page 14.

Financial review

Analysis of change in net interest income – volume and rate analysis

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

	2014 over 2013 Increase/(decrease) due to changes in:			2013 over 2012 Increase/(decrease) due to changes in:		
	Average volume €m	Average rate €m	Net change €m	Average volume €m	Average rate €m	Net change €m
Interest-earning assets						
Loans and advances to banks						
Domestic	(10)	(23)	(33)	(13)	5	(8)
Foreign	(20)	1	(19)	(85)	(14)	(99)
Loans and advances to customers						
Domestic	(28)	18	(10)	(166)	44	(122)
Foreign	(103)	30	(73)	(485)	81	(404)
Amounts due from ultimate holding company						
Domestic	(24)	(8)	(32)	44	25	69
Debt securities						
Domestic	(22)	(11)	(33)	(57)	(162)	(219)
Foreign	(28)	(8)	(36)	(105)	28	(77)
Total interest receivable of the banking business						
Domestic	(84)	(24)	(108)	(192)	(88)	(280)
Foreign	(151)	23	(128)	(675)	95	(580)
	(235)	(1)	(236)	(867)	7	(860)
Interest-bearing liabilities						
Deposits by banks						
Domestic	(37)	(54)	(91)	51	115	166
Foreign	(78)	31	(47)	82	(24)	58
Customer accounts: demand deposits						
Domestic	—	—	—	30	30	60
Foreign	(7)	(2)	(9)	43	12	55
Customer accounts: savings deposits						
Foreign	(14)	8	(6)	8	(1)	7
Customer accounts: other time deposits						
Domestic	(4)	(2)	(6)	24	4	28
Foreign	(20)	5	(15)	75	(17)	58
Debt securities in issue						
Domestic	(1)	(2)	(3)	96	(37)	59
Foreign	(6)	4	(2)	8	1	9
Subordinated liabilities						
Domestic	37	98	135	13	16	29
Foreign	(121)	2	(119)	41	(4)	37

Internal funding of trading business						
Foreign	2	13	15	(37)	1	(36)
Total interest payable of the banking business						
Domestic	(5)	40	35	214	128	342
Foreign	(244)	61	(183)	220	(32)	188
	(249)	101	(148)	434	96	530
Movement in net interest income						
Domestic	(79)	(64)	(143)	22	40	62
Foreign	93	(38)	55	(455)	63	(392)
	14	(102)	(88)	(433)	103	(330)

Financial review

Segment performance
In February 2014, RBS Group announced the reorganisation of the previously reported operating divisions into three franchises: Personal & Business Banking, Commercial & Private Banking and Corporate & Institutional Banking (CIB). Only CIB, comprising the former Markets and International Banking divisions, is relevant for RBSH Group CIB is a single reportable segment.

RBS Capital Resolution (RCR) was established with effect from 1 January 2014 by the transfer of capital intensive and higher risk assets from previous divisions. Non-Core was dissolved on 31 December 2013. No business lines moved to RCR and so comparative data has not been restated. RCR will be reported separately until wind-down.

The results of each segment are set out below. Services directly attributable costs have been allocated to the operating segments, based on their service usage. Where services span more than one segment an appropriate measure is used to allocate the costs on a basis which management considers reasonable. Services costs are fully allocated and there are no residual unallocated costs.

	2014	2013	2012
Operating profit/(loss) before tax	€m	€m	€m
Corporate & Institutional Banking	2	5	(321)
Central items	(106)	(359)	(535)
RCR	47	n/a	n/a
Non-Core	n/a	212	(31)
	(57)	(142)	(887)

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

	2014	2013	2012
Corporate & Institutional Banking	1,400	1,800	8,400
Central items	100	100	300
RCR	200	n/a	n/a
Non-Core	n/a	600	2,600
	1,700	2,500	11,300

Financial review

Segment performance continued
Corporate & Institutional Banking

	2014	2013	2012
	€m	€m	€m
Net interest income	134	112	422
Non-interest income	150	326	514
Total income	284	438	936
Direct expenses			
- staff costs	(21)	(70)	(602)
- other	(189)	(180)	(657)
Indirect expenses	(71)	(131)	13
Operating expenses	(281)	(381)	(1,246)
Profit/(loss) before impairment losses	3	57	(310)
Impairment losses	(1)	(52)	(11)
Operating profit/(loss) before tax	2	5	(321)
	€bn	€bn	€bn
Balance sheet			
Third party assets	12	16	34
Third party liabilities	12	16	43

2014 compared with 2013
Operating profit before tax was €2 million compared with a profit of €5 million in 2013.

Total income decreased by €154 million to €284 million mainly attributable to a decrease in non-interest income.

Net interest income increased by €22 million to €134 million compared with €112 million in 2013.

Non-interest income decreased by €176 million to €150 million in 2014 compared with €326 million in 2013, reflecting reduced deployment of resources.

Operating expenses decreased by €100 million to €281 million compared with €381 million in 2013. This reflected the continued focus on cost savings across both business and support areas and the transfer of businesses to RBS plc.

Impairment losses were €1 million compared with €52 million in 2013, reflecting a low level of new impairments. The impairments in 2013 reflected a small number of single name provisions.

2013 compared with 2012
Operating profit before tax was €5 million compared with a loss of €321 million in 2012. This improvement of €326 million was mainly due to lower operating expenses.

Total income decreased by €498 million to €438 million mainly attributable to a decrease in net-interest income.

Net interest income decreased by €310 million to €112 million compared with €422 million in 2012. This reflects the transfer of businesses to RBS plc.

Non-interest income decreased by €188 million to €326 million in 2013 compared with €514 million in 2012, primarily due to lower fee and trading income as a result of the transfer of businesses to RBS plc. This was offset by lower losses in other operating income.

Operating expenses decreased by €865 million to €381 million compared with €1,246 million in 2012. This reflects the continuing transfer of businesses to RBS plc.

Impairment losses increased by €41 million to €52 million compared with €11 million in 2012. The impairments in 2013 and 2012 reflect a small number of single name provisions.

Financial review

Segment performance continued

Central items

	2014	2013	2012
	€m	€m	€m
Central items not allocated	(106)	(359)	(535)

2014 compared with 2013

Central items not allocated were €106 million compared with €359 million in 2013. Items not allocated in the year mainly relates to the loss on the sale of available-for-sale securities partially offset by an increase in profits from interests in associates.

2013 compared with 2012

Central items not allocated reduced €176 million to €359 million mainly reflecting lower own credit adjustment attributable to the tightening of credit spreads.

Financial review

Segment performance continued
RBS Capital Resolution (RCR)

	2014
	€m
Net interest income	65
Non-interest income	1
Total income	66
Direct expenses	
- staff costs	(6)
- other	(11)
Indirect expenses	(10)
Operating expenses	(27)
Profit before impairment losses	39
Impairment releases	8
Operating profit before tax	47
	€bn
Balance sheet	
Third party assets	4
Third party liabilities	4

2014
Operating profit before tax of €47 million reflects the benefit received from life settlement and project finance income.

Operating expenses of €27 million is largely as a result of costs associated with RCR disposal activity.

The favourable market and economic conditions resulted in an €8 million impairment release.

Financial review

Segment performance continued
Non-Core

	2013	2012
	€m	€m
Net interest income	138	217
Non-interest income	106	(15)
Total income	244	202
Direct expenses		
- staff costs	(31)	(77)
- other	(38)	(115)
Indirect expenses	(19)	(10)
Operating expenses	(88)	(202)
Profit/(loss) before impairment releases/(losses)	156	—
Impairment (releases)/losses	56	(31)
Operating profit/(loss) before tax	212	(31)
	€bn	€bn
Balance sheet		
Third party assets	7	8
Third party liabilities	6	5

Non-Core was dissolved on 31 December 2013.

2013 compared with 2012
Operating profit before tax was €212 million compared with a loss of €31 million in 2012, largely due to higher total income, lower expenses and impairment releases.

Total income increased by €42 million to €244 million compared €202 million in 2012 mainly due to higher non-interest income.

Net interest income decreased by €79 million to €138 million compared with €217 million in 2012 following continuing Non-Core disposals.

Non-interest income increased by €121 million to €106 million compared with a loss of €15 million in 2012.

Operating expenses decreased by €114 million to €88 million compared with €202 million in 2012, reflecting continuing disposals.

Impairment releases were €56 million compared with losses of €31 million in 2012.

Financial review

Consolidated balance sheet at 31 December 2014

	2014	2013	2012
	€m	€m	€m
Assets			
Cash and balances at central banks	1,135	3,193	2,294
Loans and advances to banks	7,696	5,695	12,206
Loans and advances to customers	3,539	3,784	6,380
Amounts due from ultimate holding company	123	2,820	2,949
Debt securities and equity shares	3,243	15,583	23,782
Settlement balances	40	10	31
Derivatives	4,432	4,782	7,555
Deferred tax	34	40	420
Interests in associates	947	785	734
Prepayments, accrued income and other assets	1,105	1,068	799
Assets of disposal groups	1,257	2,048	13,804
Total assets	23,551	39,808	70,954
Liabilities			
Bank deposits	4,542	7,233	21,841
Repurchase agreements and stock lending	636	11,710	12,624
Deposits by banks	5,178	18,943	34,465
Customer accounts	2,934	4,151	2,638
Debt securities in issue	1,017	1,319	2,602
Settlement balances and short positions	34	105	107
Derivatives	4,555	5,862	9,644
Accruals, deferred income and other liabilities	1,122	1,065	1,782
Deferred tax	88	63	40
Subordinated liabilities	5,104	4,951	6,851
Liabilities of disposal groups	46	407	11,026
Total liabilities	20,078	36,866	69,155
Total equity	3,473	2,942	1,799
Total liabilities and equity	23,551	39,808	70,954

Financial review

Commentary on consolidated balance sheet
2014 compared with 2013
Total assets were €23.6 billion at 31 December 2014, a decrease of €16.2 billion, or 41%, compared with €39.8 billion at 31 December 2013.

Cash and balances at central banks decreased by €2.1 billion or 64% to €1.1 billion at 31 December 2014 reflecting reduced liquidity requirements.

Loans and advances to banks increased by €2.0 billion, or 35%, to €7.7 billion at 31 December 2014, principally due to an increase in balances with fellow subsidiaries.

Loans and advances to customers declined €0.2 billion, or 6%, to €3.5 billion, reflecting repayments and business run-down.

Debt securities and equity shares decreased by €12.3 billion, or 79%, to €3.2 billion at 31 December 2014, mainly reflecting the sale of €9.0 billion of securities held as part of the liquidity portfolio.

Derivative assets decreased by €0.4 billion, or 7%, to €4.4 billion, and derivative liabilities decreased by €1.3 billion, or 22%, to €4.6 billion mainly reflecting reduced deployment of resources.

The decrease in assets and liabilities of disposal groups is due to the completion of transfers to RBS plc in 2014. These businesses were included in held for disposal as at 31 December 2013.

Deposits by banks decreased by €13.8 billion, 73%, to €5.2 billion, with lower repurchase agreements and stock lending (repos), down €11.1 billion to €0.6 billion. This reduction is mainly due to planned reductions in funding from RBS plc in addition to the transfer of businesses to RBS plc during the year.

Customer accounts were down €1.2 billion, 29%, to €2.9 billion, mainly reflecting balance sheet reduction in CIB and RCR.

Debt securities in issue declined €0.3 billion, 23%, to €1.0 billion largely reflecting decreases in medium-term-notes in CIB.

Owners' equity increased by €0.5 billion, 18%, to €3.5 billion, largely due to favourable mark-to-market movements on available-for-sale debt securities offset by an ordinary dividend of €300 million.

2013 compared with 2012
Total assets were €39.8 billion at 31 December 2013, a decrease of €31.2 billion, or 44%, when compared with €71.0 billion at 31 December 2012.

Cash and balances at central banks increased by €0.9 billion or 39% to €3.2 billion at 31 December 2013.

Loans and advances to banks decreased by €6.5 billion, or 53%, to €5.7 billion at 31 December 2013 principally due the transfer of businesses to RBS plc during the year.

Loans and advances to customers declined €2.6 billion, or 41%, to €3.8 billion. This reflected the transfer of businesses to RBS plc during the year, in particular within CIB.

Debt securities decreased by €7.4 billion, or 33%, to €15.3 billion, reflecting bond maturities, the transfer of businesses to RBS plc and the sale of part of the liquidity portfolio.

Equity shares decreased by €0.8 billion, or 74%, to €0.3 billion. This reflected the transfer of businesses to RBS plc.

Derivative assets decreased by €2.8 billion, or 37%, to €4.8 billion, and Derivative liabilities decreased by €3.8 billion, or 39%, to €5.9 billion, this was largely attributable to the transfer of businesses to RBS plc.

The decrease in assets and liabilities of disposal groups is due to the completion of transfers to RBS plc in 2013. These businesses were held for disposal as at 31 December 2012.

Deposits by banks decreased by €15.5 billion, 45%, to €18.9 billion, with lower repurchase agreements and stock lending (repos), down €0.9 billion, 7%, to €11.7 billion. This reduction is mainly due to the transfer of businesses to RBS plc during the year. In addition the decrease is due to planned reductions in funding from RBS plc.

Customer accounts were up €1.5 billion, 57%, to €4.2 billion.

Debt securities in issue declined €1.3 billion, 49%, to €1.3 billion largely decreases in notes and commercial paper reflecting reduced positions in CIB and Treasury.

Owners' equity increased by €1.1 billion, 64%, to €2.9 billion, largely due to favourable mark-to-market movements on available-for-sale debt securities, offset by the attributable loss in the year.

Capital and risk management

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Presentation of information

Except as otherwise indicated by an asterisk (*), information in the Capital and risk management section (pages 25 to 78) is within the scope of the Report of independent registered public accounting firm.

Capital and risk management are conducted on an overall basis within RBS Group. Therefore the discussion on Capital and risk management on pages 25 to 78 refer principally to policies and procedures in RBS Group that also apply to RBSH Group.

Risk governance*

Governance structure

Capital and risk management strategies are owned and set by the Managing Board of RBSH Group and are implemented by the executive management. There are a number of committees and executives that support the execution of the business plan and strategy. Two of these committees are dedicated to RBSH Group and report to the RBSH Group Managing Board. These are depicted and described in the structure chart and table below. Matters not specifically delegated are reserved for the Managing Board.

There are also risk functions and committees that cover RBS Group and (parts of) RBSH Group reflecting the integrated manner in which the business is managed within RBS Group. Service Level Agreements are in place between RBSH Group and RBS Group to accommodate this integrated risk management oversight, including escalation procedures to the RBSH Group Managing Board as appropriate.

During 2014 the RBSH Group Chief Risk Officer had a reporting line into the CRO of Divested Businesses.

Risk management within RBSH Group focuses on all material risks including credit, market, operational, regulatory and country risk and business activities. Liquidity risk and the day-to-day management of liquidity and funding of the book are the responsibility of RBSH Group Treasury.

For a summary of the main risk types faced by RBSH Group and how it manages each of them, refer to pages 33 and 34.

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Risk governance*
RBS Group governance structure
RBS Group is committed to achieving the highest standards of corporate governance in every aspect of its business, including risk management. A key aspect of the Board's responsibility as the main decision-making body is the setting of risk appetite (refer to page 31 for more information on risk appetite) to ensure that the levels of risk RBS Group is willing to accept in the attainment of its strategic business and financial objectives are clearly understood. The Board delegates authority for risk management to specific committees.

The risk governance structure and the main purposes of each of the committees is illustrated below:

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The following table shows details of the key RBSH Group Board and Committees and their responsibilities.

Board/Committee	Responsibilities
Supervisory Board Membership: Consists of three members. Three are executives of RBS Group.	The Supervisory Board is responsible for supervising RBSH Group’s management and RBSH Group’s general affairs and the business connected with it as well as for advising the Managing Board.
Managing Board Membership: Four members led by the RBSH Group Chairman, RBSH Group Chief Administrative Officer (CAO), RBSH Group Chief Financial Officer (CFO), RBSH Group Chief Risk Officer (CRO)	Reports to the Supervisory Board. It is the principal decision-making forum for the RBSH Group, setting policy framework, operating structure and yearly plan (including objectives and budgets). All members of the Managing Board have responsibility for RBSH Group. As well as their overall corporate responsibilities, the members of the Managing Board manage one or more units, for which they have primary responsibility.
RBSH Group Risk and Control Committee (RCC) Membership: Chaired by the RBSH Group CRO. Members include Chairman Managing Board, RBSH Group CFO, Senior N.V. Risk Manager, N.V. delegate of RBS Group Credit, Market, and Operational Risk, RBS N.V. Head of Conduct & Regulatory Affairs, Chief Risk Officer Asia.	The responsibilities of the RCC include: · Advising the Managing Board on the risk appetite of the RBSH Group and receiving direction from the Managing Board on the risk appetite; · Providing input to the RBSH Group risk-appetite-setting process in the context of the Group’s overall risk appetite; · Overseeing the risk framework within RBSH Group and report directly to the RBSH Group Managing Board on the performance of the framework and on issues arising from it; · Monitoring the actual risk profile of RBSH Group, ensuring that this remains within the boundaries of the agreed risk appetite or else escalating excesses to the RBSH Group Managing Board. Prior to escalation, the RCC can ask the appropriate risk committee in RBS Group or in the business that normally monitors and controls the risk item to address any excess. · The remit of the Committee also includes Credit, Market, Operational and Regulatory Risk within RBS N.V.. Changes to the Terms of Reference of the RBSH Group RCC must be approved by the RBSH Group Managing Board. To execute its authority the RCC has access to all relevant risk information relating to RBSH Group available within RBS Group including escalations from and to Group or segmental Committees.

RBSH Group Asset and Liability Committee (ALCo) Membership: Seven permanent voting members led by the RBSH Group Chairman for the Managing Board, RBSH Group CFO, RBSH Group CAO, RBSH Group CRO, RBS N.V. Treasurer, RBS Group Treasurer and Global Head of Equity and Liquidity.	The mandate of ALCo covers the following specific areas in respect of RBSH Group: · The overall governance responsibility for the strategic management of the RBSH Group Balance Sheet; · The review, approval and allocation of balance sheet, capital, liquidity and funding limits; · The liquidity, funding, foreign exchange and interest rate exposures of RBSH Group's balance sheet; · The balance sheet structure and risk-weighted assets position of RBSH Group; · Decisions on capital repatriation and loss coverage; · Compliance with all regulatory requirements at all times; · The implementation and maintenance of transfer pricing policies (although setting the liquidity spread curve remains the responsibility of the RBS Group ALCo; · The approval and implementation within RBSH Group of RBS Group Treasury policies and procedures; and · RBSH Group ALCo is responsible for oversight of retained business (shared assets) and residual ABN AMRO business.

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Three lines of defence

The three lines of defence model is used industry-wide for the management of risk. It provides a clear set of principles by which to implement a cohesive operating model, one that defines accountabilities and responsibilities for managing risk across the organisation.

First line of defence - Management and supervision

The first line of defence includes customer franchises, Technology and Operations and support functions such as HR and Communications. Responsibilities include:

- Owning, managing and supervising, within a defined risk appetite, the risks which exist in the business area.
- Ensuring appropriate controls are in place to mitigate risk: balancing control, cost, customer service and competitive advantage.
- Ensuring that the culture of the business supports balanced risk decisions and compliance with policy, laws and regulations.
- Ensuring that the business has effective mechanisms for identifying, reporting and managing risk and controls.

Second line of defence - Oversight and control

The second line of defence includes RBS Group Risk Management and RBS Group Conduct and Regulatory Affairs.

Responsibilities include:

- Owning and developing the risk and control policies, limits and tools for the business to use to discharge its responsibilities.
- Overseeing and challenging the management of risks and controls.
- Leading the design, development and communication of the bank's risk culture and appetite.
- Analysing the aggregate risk profile and ensuring that risks are being managed to the desired level (risk appetite).
- Providing expert support and advice to the business on risk management.
- Providing senior executives with relevant management information and reports and escalating concerns where appropriate.
- Undertaking assurance.

Third line of defence - Internal Audit

Responsibilities include:

- Providing assurance on the key risks to the organisation by assessing the entire control framework.
- Holding RBS Group Risk Management accountable for establishing an appropriate risk management framework.

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Management structure
RBS Group's management structure and the main elements of each role are illustrated below.

Notes:
(1) RBS Group Risk Management
The RBS Group Chief Risk Officer (CRO) leads RBS Group Risk Management. The CRO reports directly to the RBS Group Chief Executive and the Board Risk Committee, with a right of access to the Chairman of the Board Risk Committee.

RBS Group Risk Management is an independent function, structured by risk discipline to facilitate the effective management of risk.

In 2014, Risk Management, which had previously been spread across the different business segments, re-organised itself into five functional areas: Operational Risk, Support Functions & Divested Businesses; Credit Risk; Market Risk; Enterprise-Wide Risk Management and Risk Infrastructure. Directors of Risk were also appointed for each of the franchises and for Services. The streamlined structure consolidates risk information, allowing for more efficient decision-making.

The directors of risk functions are responsible for RBS Group-wide risk appetite and standards within their respective disciplines and report directly to the CRO.

CROs are in place for certain jurisdictions and legal entities to meet local regulatory and governance requirements. They lead the risk management teams locally in support of functional risk heads where teams follow a functional operating model. The key CRO roles report directly to the RBS Group CRO.

Risk committees in the customer businesses oversee risk exposures arising from their business activities and focus on ensuring that they are adequately monitored and controlled.

(2) Conduct and Regulatory Affairs
Conduct & Regulatory Affairs (C&RA) is led by the Chief Conduct & Regulatory Affairs Officer, who reports directly to the Chief Executive. It is responsible for providing oversight of conduct risk and regulatory risk at RBS Group, and does so by setting bank-wide policy and standards, providing advice to each customer business, and ensuring that the mitigating controls are suitable. C&RA also provides leadership of the bank's relationships with its regulators.

The functional heads (the directors of Remediation, Compliance Services, RBS Americas, Financial Crime, Regulatory Affairs and Advisory) report directly to the Chief Conduct & Regulatory Affairs Officer. Each is responsible, where appropriate, for the bank-wide risk appetite and standards of their respective areas:

A Chief Compliance Officer in each franchise, reporting to the Director of C&RA Advisory, provides advisory support to assist businesses in their management of conduct, regulatory affairs and financial crime.

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Risk appetite and culture*

Risk appetite

RBSH Group's risk appetite establishes the level and type of risk that it is willing to accept in order to meet its strategic objectives and its wider obligations to stakeholders.

RBSH Group has developed a framework that sets and implements an appropriate risk appetite supported by a regular monitoring and review process. A risk appetite statement setting out overall risk limits for different risk types is approved by the Supervisory Board. Risk appetite limits and risk exposures are reported monthly to the Risk & Control Committee, the Managing Board and the Supervisory Board. Any limit breach is reported to the Managing Board. The Managing Board may grant a temporary waiver or require the position to be adjusted to comply with the risk limit.

Strategic risk objectives

Risk management plays an integral role in the delivery of strategic goals. The implementation of a stronger and more effective culture of risk management and control provides the platform necessary to address vulnerabilities, rebuild on core strengths and position RBS Group on a sustainable and profitable path for future growth.

Financial strength and resilience are at the heart of the strategic plan. RBS Group has defined this level of robustness as that which is capable of achieving and sustaining a standalone credit rating (i.e. without government support) that is in line with those of its strongest international peers.

Given this central aim, the RBS Group Board has set out four key strategic objectives, aligned with the strategic plan:

- Maintain capital adequacy.
- Deliver stable earnings growth.
- Ensure stable and efficient access to funding and liquidity.
- Maintain stakeholder confidence.

Each objective is essential in its own right, but also mutually supportive of the others. The strategic risk objectives are the bridge between the RBS Group-wide business strategy and the frameworks, limits and tolerances that are used to set risk appetite and manage risk in the business franchises on a day-to-day basis.

This is how the strategic plan is brought to life in our management of risk:

Risk appetite measures

A range of different but complementary tools has been developed to measure whether strategic plans are consistent with risk appetite, to test broader 'what if' questions and to assess the impact of changes in key assumptions:

- Stress testing - assesses how earnings, capital and funding positions change under an unfavourable, yet plausible, scenario. Stress scenarios can differ by theme, geographical location or severity.

- Economic capital - provides complementary insights, with a breadth of understanding of risk profile changes and 'tail risks' across millions of different modelled scenarios.

- Sensitivity analysis - provides 'ready reckoners' around changes in key variables. It offers a high-level view on questions such as 'what if gross domestic product worsened by a further 1%', identifying certain tipping points where the bank's risk profile moves outside appetite.

Risk control frameworks and limits

Risk control frameworks and their associated limits are an integral part of the risk appetite framework and a key part of embedding risk appetite targets in day-to-day risk management decisions. The risk control frameworks manage risk by expressing a clear tolerance for material risk types that is aligned to business activities.

The Group Policy Framework directly supports the qualitative aspects of risk appetite, helping to rebuild and maintain stakeholder confidence in RBS Group's risk control and governance. Its integrated approach is designed to ensure that an appropriate standard of control is set for each of the material risks it faces, with an effective assurance process put in place to monitor and report on performance. Risk appetite has its own policy standard within the Group Policy Framework. This standard sets out clear roles and responsibilities to set, measure, cascade and report performance against risk appetite, and provides assurances that business is being conducted within approved risk limits and tolerances.

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Financial review Capital and risk management

Culture, values and remuneration

Objectives for risk culture

The establishment of a strong risk culture is essential to the realisation of RBS Group's ambition to build "a truly customer-centric bank". A strong risk culture is a key part of ensuring risk appetite is effectively embedded across RBS Group. The link between risk appetite and strategic objectives encourages people at all levels of the business to think about risk, how they identify it and how they manage it. It incorporates the quantitative and qualitative aspects of risk and uses both absolute and relative risk measures.

Risk culture policies

A core principle behind the development of the risk appetite framework is that risk appetite contributes to a strong risk management culture, in which risk is clearly and meaningfully aligned with business behaviours and outcomes. RBS Group's values - of "serving customers", "working together", "doing the right thing" and "thinking long term" - act as a clear starting point for a strong and effective risk culture. A wide range of communication and engagement activities (detailed below) has been undertaken to discuss the meaning of each value with employees and how they affect and guide day-to-day activities.

The embedding of RBS Group's values into a strong risk culture is supported by a revised and more focused Code of Conduct. The Code provides guidance on expected behaviour and sets out the standards of conduct that support the values. It explains the effect of decisions that are taken and describes the principles that must be followed.

These business principles cover conduct-related issues as well as wider business activities. They focus on desired outcomes, with practical guidelines to align the values with commercial strategy and actions. The embedding of business principles facilitates sound decision making and a clear focus on good customer outcomes in 'the moments that matter'. It is aligned with the people management and remuneration processes to support a positive and strong risk culture through appropriate incentive structures.

A simple decision-making guide (called the "YES check") has been included in the Code of Conduct. It is a simple, intuitive set of five questions, designed to ensure the values guide day-to-day decisions:

- Does what I am doing keep our customers and RBS Group safe and secure?
- Would customers and colleagues say I am acting with integrity?
- Am I happy with how this would be perceived on the outside?
- Is what I am doing meeting the standards of conduct required?
- In five years' time would others see this as a good way to work?

Each question is a prompt to think about the situation and how it fits with RBS Group's values. It ensures that employees can think through decisions that do not have a clear answer, guiding the judgements behind their decisions and actions.

Training

Across the risk management function, a series of events and activities have been undertaken to bring alive the bank's values and culture for employees. This is supported by performance management processes that hold individuals to account for poor behaviour and reward the behaviour that supports the bank's purpose, vision and values.

RBS Group Risk Management runs a Risk Academy which helps to train staff and to spread a common risk culture across the bank. Training plans are aligned with Risk function strategy to ensure staff have the skills and capabilities to support business and to meet changing regulatory and policy requirements.

Risk-based key performance indicators

RBS Group-wide remuneration policy requires remuneration to be aligned with, and to support, effective risk management. The policy ensures that the remuneration arrangements for all employees reflect the principles and standards prescribed by the UK Remuneration Code. For further information refer to page 152.

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Financial review Capital and risk management

Risk coverage

The main risk types faced by RBSH Group are presented below.

Risk type	How the risk arises	2014 overview
Conduct and legal risk	Conduct risk can result in fines and reputational damage if customers are not treated in line with their and other stakeholders' expectations. Conduct risk exists across all stages of the RBSH Group's relationships with its customers, from sales through service delivery to post-sales processes. It also exists in the activities RBS Group undertakes to manage its business, from the development of business strategies, through governance and human resource management. Conduct risk also exists if the RBSH Group does not take effective action to prevent fraud, bribery and money laundering.	RBS Group continued to remediate historical conduct issues, while also restructuring its customer-facing businesses and support functions around the needs of its customers. In RBSH Group (legacy) rate setting has also been the primary focus from a conduct perspective. Although the impact of conduct risk is considered less of a concern for RBSH Group at the end of 2014, it remains of high priority due to its importance to RBS values.
Regulatory risk	Regulatory risk arises from the RBSH Group's regulatory, business or operating environments and from how it responds to them.	The level of regulatory risk remained high for RBS Group as policymakers and regulators continued to strengthen regulations and supervision in response to the events of 2007 and 2008. For RBSH, regulatory risk is continuously decreasing as a result of significant reduction of the balance sheet of RBSH and the on-going sale of front line businesses.
Operational risk	Operational risk may arise from a failure to manage operations, transactions and assets appropriately. It may arise from human error, an inability to deliver change on time or adequately, or the unavailability of technology services or the loss of customer data. Fraud and theft are sources of operational risk, as is the impact of natural and man-made disasters. It may also arise from a failure to take appropriate measures to protect assets or take account of changes in law.	To ensure operational risk is managed in a more standardised and consistent manner, work was started to enhance the operational risk management framework (ORMF). The threat to the security of RBS Group's information from cyber attacks is a key focus for operational risk as well as measures to address weaknesses after the major IT incident of 2012.
Capital adequacy risk	Capital adequacy risk arises from inefficient management of capital resources.	The RBSH Group's Core Tier 1 ratio on a CRR transitional basis was 16.2%. RBSH Group plans for and maintains an adequate amount and mix of capital consistent with its risk profile. The amount of capital

		required is determined through risk assessment and stress testing.
Liquidity and funding risk	Liquidity and funding risk arise through the maturity transformation role that banks perform. RBSH Group exposed to capital adequacy risk if it manages its capital resources inefficiently. Liquidity and funding risk arises from day-to-day operations.	As one of the primary operating entities of the RBS Group, RBSH Group's liquidity risk is monitored and managed centrally by the RBS Group in line with policies and processes set by the RBSH Group's Managing Board.
Reputational risk	Reputational risk can arise from the conduct of either RBSH Group as a whole or that of the individuals it employs; as well as its wider conduct, policies and practices.	The most material threat to RBSH Group's reputation continued to originate from historical conduct deficiencies. RBSH Group has been the subject of investigations and review in relation to (legacy) rate setting concerns, some which have resulted in dismissals.

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Risk type	How the risk arises	2014 overview
Credit risk	The risk that RBSH Group will incur losses owing to the failure of a customer or counterparty to meet its obligations to settle amounts outstanding.	The RBSH Group manages credit risk based on a suite of credit approval and risk concentration frameworks and associated risk management systems and tools. Credit risk RWAs were €18.2 billion at 31 December 2014.
Market risk	The majority of the RBSH Group's traded market risk exposure arises in CIB and RCR through transactions in financial instruments including debt securities, loans, deposits and equities, as well as securities financing and derivatives. The majority of its non-traded market risk exposure arises from commercial banking activities from assets and liabilities that are not classified as held for trading.	Market risk RWAs remained broadly flat at €1.2 billion.
Country risk	Country risk arises from possible economic or political events in each country to which the RBSH Group has exposure, and from unfavourable conditions affecting daily operations in a country. It has the potential to affect all parts of the RBSH Group's portfolio across wholesale and retail activities that are directly or indirectly linked to the country in question. The activities of several customer businesses, particularly CIB, expose the RBSH Group to country risk.	The RBSH Group maintained a cautious stance as many clients continued to reduce debt levels. Balance sheet exposure to the eurozone countries continued to fall, and was down €6.8 billion to €2.5 billion reflecting risk reduction and capital management focus.
Business risk	Business risk exists at all levels of the organisation and is generated at the transaction level. It is affected by other risks the RBSH Group faces, which could contribute to any adverse changes in the bank's revenues or costs.	RBSH Group reduced its business risk profile as it made disposals through RCR, sold a large part of its Liquidity Portfolio and transferred out its business in Thailand.
Strategic risk	Strategic risk arises from strategic decisions that fail to reflect the operating environment, or which do not take adequate account of execution challenges. These include decisions related to the RBS Group products and	RBS Group announced the results of a strategic review with a defined plan to shift the business mix towards the UK and the retail and commercial banking segments, with the aim of a lower risk

services which have implications for profitability, risk, the customer base, and for business growth.	profile.

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Financial review Capital and risk management

Conduct risk*

Definition

Conduct risk is the risk that the behaviour of RBSH Group 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. The damage or loss may be the result of breaches of regulatory rules or laws, or of failing to meet customers' or regulators' expectations.

Sources of risk

Conduct risk exists across all stages of RBSH Group's relationships with its customers, from the development of its business strategies, through governance arrangements, to post-sales processes. Activities through which conduct risk may arise are diverse and include product design, marketing and sales, complaint handling, staff training, and handling of confidential and non-public price sensitive information. Conduct risk also exists if RBSH Group does not take effective action to prevent fraud, bribery and money laundering.

Governance

Effective conduct risk management is a commercial imperative for the bank: customers, clients and counterparties demand it as a precursor to building trust.

Conduct & Regulatory Affairs (C&RA) is responsible for defining appropriate standards of conduct, and for designing the framework for managing conduct risk, driving adherence, and overseeing remediation activity. It also provides appropriate controls, challenge and oversight to ensure good customer outcomes. In so doing, C&RA acts as a second line of defence control function.

Key elements of the governance structure are set out below:

- The C&RA Executive Committee considers emerging issues material to the C&RA strategy, and implements Board and Executive Committee risk management policy decisions; and

- The Financial Crime Accountable Executive Committee (accountable to the Executive Risk Forum) ensures that the customer businesses and the Services function fulfil strategic objectives by identifying and managing their financial crime risks effectively.

Controls and assurance

Under the RBS Group Policy Framework, C&RA owns 26 conduct risk policies, grouped under employee, corporate and market conduct, and; and conduct towards customers. Each policy is designed to provide both high-level direction and RBS Group-wide requirements. The policies and chapters are designed to ensure RBS Group meets its regulatory obligations; and to provide the necessary clarity for staff on their conduct obligations.

Assurance and monitoring activities are essential to help measure the extent to which RBS Group manages its delivery of specific customer outcomes. During 2014, in addition to the provision of risk-based assurance over key conduct, financial crime, systems and infrastructure topics, the C&RA assurance function provided RBS Group-wide assurance in support of Financial Conduct Authority (FCA) attestations, principally those relating to complaints and anti-money laundering (AML).

Risk assessments are used to identify material conduct risks and key controls across all business areas. The risk assessment process is designed to confirm that risks are effectively managed and prioritised and controls are tested to verify that they operate effectively.

Scenario analysis is used to assess the impacts of extreme but plausible conduct risks including financial crime. The scenarios assess the exposures that could significantly affect RBS Group's financial performance or reputation and are an important component in the operational risk framework and capital model.

Risk appetite

RBS Group has articulated a customer-focused vision to be the leading UK bank for trust, customer service and advocacy by 2020. In line with this, C&RA has evolved from focusing on policy compliance towards considering the wider business implications of placing customers at the heart of the business.

A conduct risk appetite framework is being developed to ensure that RBS Group's risk profile is based on its strategic risk objectives, with quantitative targets supplemented by qualitative criteria focused on attaining good customer outcomes, upholding market integrity, meeting stakeholder expectations and promoting a strong risk culture. Work to refine and embed the risk appetite framework and associated control processes continues in 2015.

Risk monitoring and measurement

C&RA works closely with the customer facing businesses to assess business models, strategy and products and influence better outcomes for customers.

RBS Group's senior boards and committees receive updates on conduct risk exposures and action plans through monthly C&RA initiated reporting. The reporting has been enhanced to be more focused, forward-looking and action-oriented.

An annual Money Laundering Reporting Officer's Report is submitted to the RBS Group Board and the FCA. Covering the operation and effectiveness of the systems and controls in place to comply with Anti-Money Laundering law and regulation, it also describes RBS Group's AML framework. In addition, it covers the systems and controls in place to prevent the financing of terrorism and to ensure compliance with sanctions as well as embargoes and export controls imposed by the UN, governments and other supranational bodies.

The RBS Group Audit Committee is provided with an annual Whistleblowing Update Report. It details cases by internal reporting categories based on the Public Interest Disclosure Act (1998) category, identifies underlying causal and subject trends, and highlights the outcome of investigations and actions taken.

C&RA is working with the business franchises to define the data required to ensure appropriate customer outcomes are delivered and are compliant with the Basel Committee on Banking Supervision principles for effective risk data aggregation and risk reporting. RBS Group's ability to aggregate, analyse and report conduct risk internally is being enhanced so it can assess the effectiveness of mitigating actions.

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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.

Operational risks may have a direct customer or reputational impact (for example, a major IT systems failure or fraudulent activity) or both. Operational risk failures may also have a link with conduct risk as evidenced by customer complaints made in connection with Payment Protection Insurance.

Sources of risk

Operational risk may arise from a failure to manage operations, transactions and assets appropriately. It may arise from forms of human error, an inability to deliver change on time or adequately, or the unavailability of technology services or the loss of customer data. Fraud and theft are sources of operational risk, as is the impact of natural and man-made disasters. It may also arise from a failure to take appropriate measures to protect assets or take account of changes in law.

Governance

A strong operational risk management function is vital to support profitability. Better management of operational risk directly supports RBS Group's strategic objective of improving stakeholder confidence and is vital for stability and reputational integrity.

The operational risk function, an independent second line of defence, plays a leadership role and seeks to achieve a robust risk management framework and culture across the bank.

The operational risk function is responsible for the design and maintenance of the Operational Risk Management Framework. The Operational Risk Policy and associated standards are incorporated in the RBS Group Policy Framework and provide direction for the consistent identification, assessment, management, monitoring and reporting of operational risk.

The Operational Risk Executive Committee (OREC), which is a sub-committee of the Executive Risk Forum, acts on all operational risk matters. This includes; identifying and assessing material operational risks, encompassing both current and emerging material risks; reviewing and monitoring the operational risk profile; and reviewing and approving material policy changes.

Controls and assurance

Control Environment Certification (CEC) is used to review and assess the internal control framework.

Risk appetite

RBSH Group's operational risk appetite statement is agreed by the RBSH Group Managing and Supervisory Board. It comprises a number of specific measures of risk. To confirm that RBSH Group operates within the set risk appetite, the high-level statement is supplemented by specific tolerances for different types of operational risk. Operational risk appetite measures and frameworks are reviewed regularly and approved by the Supervisory Board.

The objective of operational risk management is not to remove operational risk altogether, but to manage it to an acceptable level, taking into account the customer journey and the cost of minimising the risk against the resultant reduction in exposure. Strategies to manage operational risk include avoiding undertaking a particular type of activity or operating in a particular market; transferring the risk to a third party; accepting the risk as a cost of doing business; or mitigating the risk by implementing controls.

Risk identification and assessment
Risk assessments are used to identify and assess material operational risks and key controls across all business areas. To provide a consistent categorisation of risks and controls across RBS Group and to support identification of risk concentrations, all risks and controls are mapped to the risk taxonomy and the control catalogue. Risk assessments are refreshed at least annually to ensure they remain relevant and capture any emerging risks.

The process is designed to confirm that risks are effectively managed and prioritised in line with the stated risk appetite. Controls are tested frequently to verify that they remain fit for purpose and operate effectively. Risk assessments are typically commenced in a workshop, bringing together subject matter experts and key stakeholders from across the bank. Financial and non-financial risk impacts are captured and a risk appetite decision is made.

In 2014 there was a continued focus on implementing and embedding risk assessments across the bank. This included the strengthening of links between risk assessments and other elements of the operational risk framework. In 2015, the risk framework will be further enhanced.

The New Product Risk Assessment (NPRA) process aims to ensure that the risks represented by new products (and material variations to existing products) are identified and assessed before launch. There is now a requirement to demonstrate that all products provide fair outcomes to customers.

Risk mitigation
Risks are mitigated by a suite of regularly assessed controls but, where the residual exposure is outside of risk appetite, the relevant customer business must decide how to reduce it.

RBS Group purchases insurance to provide the business with financial protection against specific losses and to comply with statutory or contractual requirements.

Risk monitoring
Monitoring and reporting are part of RBS Group’s operational risk management processes, which aim to ensure that risks and issues are identified, escalated and managed quickly.

Risk measurement
Scenario analysis is used to assess the impact of extreme but plausible operational risks and is a key input to the capital model. It provides a forward-looking basis for managing risk exposures, with a structured and consistent approach to scenario scoping and measurement.

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Event and loss data management

The event and loss data management process aims to ensure compliance with standard requirements for the management of operational risk events and the capture of loss data. It also entails reporting operational risk events that meet defined threshold criteria to RBSH Group senior management. RBS Group has continued to focus on the timely and accurate capture of operational risk losses; the use of a single RBS Group-wide repository of operational risk events; and the escalation of material operational risk events.

All losses and recoveries associated with an operational risk event are reported against their financial accounting date. 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 2014 may relate to events that occurred, or were identified in, prior years.

Capital

RBSH Group calculates the Pillar 1 capital requirement for operational risk using the standardised approach. For 2014, RBSH Group’s minimum Pillar 1 capital requirement was €58 million.

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Regulatory risk*
Definition
Regulatory risk is the risk of material loss or liability, legal or regulatory sanctions, or reputational damage, resulting from the failure to comply with (or adequately plan for changes to) relevant official sector policy, laws, regulations, or major industry standards.

Sources of risk
Regulatory risk arises from the regulatory, business or operating environment and from RBSH Group's response to it.

Governance
C&RA maintains well-established policies and supporting processes to ensure timely identification of, and effective responses to, changes in official requirements affecting the bank. C&RA also maintains a structured and open engagement with regulators. That engagement underpins a range of other policies and processes that address on-going compliance with regulatory obligations (refer to the section on conduct risk for further information).

To help manage the risks, the Mandatory Change Advisory Committee (MCAC), chaired by C&RA, was established. The MCAC reports to the Bank-Wide Investment Committee, and comprises representatives of the bank's customer businesses and functions. The MCAC acts as the 'reception committee' for reviewing externally mandated changes that may affect RBS Group and recommending appropriate responses, including the timely mobilisation of change implementation activities. In doing so, it agrees business or function owners of individual risks; and commissions and reviews impact assessments from customer businesses and functions. RBS Group Board and Executive Committee oversight of changes to regulatory requirements is supported by the MCAC (refer to above).

C&RA's Regulatory Developments team maintains and develops RBS Group Political, Legislative and Regulatory Environment Policy and supporting documents, together with associated processes, tools and governance. It also oversees the regulatory developments operating framework, to ensure it meets the needs of all businesses and functions, and maintains the Relationships with Regulators Policy.

Risk appetite
RBS Group believes that maintaining a strong regulatory risk framework is fundamental to ensuring sustainable growth, rebuilding its reputation and maintaining stakeholder confidence. Accordingly, its stated regulatory risk and compliance risk appetite is for no material or widespread breaches of rules, expectations, regulations or laws, individually or in aggregate. However, it also recognises that genuine errors occur, and so it accepts limited, non-material regulatory risk and subsequent loss.

Risk monitoring and measurement
C&RA ensures appropriate reporting of all material regulatory reviews and other regulatory developments worldwide to the appropriate bank-wide committees, including the RBS Group Board, the RBS Group Audit Committee, and the RBS Group Risk Committee. Half-yearly reporting to the Group Audit Committee also captures all material investigations and tracks the status of, and trends in, key regulatory relationships.

Regulatory risk remained a high priority during 2014, as policymakers and regulators continued to strengthen regulation and supervision in response to the events of 2007 and 2008. This resulted in high levels of interaction between RBS Group and supervisory authorities through meetings, requests for information, visits and investigations, as well as in policy developments and proposals for new rules.

Risk mitigation

C&RA also communicates information on regulatory developments and follow-up engagement with customer-facing businesses and functions, helping them identify and execute any required mitigating changes to strategy or business models. The key regulatory policies are reviewed annually.

Early identification and effective management of changes in legislation and regulation, as well as other requirements, is critical to the successful mitigation of regulatory risk. All regulatory and compliance changes are managed to ensure timely compliance readiness. Those changes assessed as having a 'high' or 'medium-high' impact are managed especially closely, with the aim of mitigating the impact through, for instance, changes to strategy or business activities, or external engagement

*unaudited

Financial review Capital and risk management

Reputational risk*

Definition

Reputational risk is the risk to RBSH Group's public image owing to a failure to meet stakeholders' expectations in relation to performance, conduct and 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 either RBSH Group as a whole or that of the individuals it employs; from the activities of customers and the countries in which they operate; from the products RBSH Group offers and the transactions it supports; and from its operations and infrastructure.

Governance

Managing reputational risk is taken very seriously, with RBS Group Board-level oversight reinforced by a Reputational Risk Policy, and by governance frameworks across business franchises.

The RBS Group Board and the Executive Committee have the ultimate responsibility for managing RBS Group's reputation although all staff have some responsibility. The RBS Group Board has set RBS Group's Purpose, Vision and Values, which outline the objective, which is "to be trusted, respected and valued by our customers, shareholders and communities". Refer to the Risk governance section on pages 26 to 30.

The Sustainable Banking Committee is responsible for overseeing and challenging how management is addressing sustainable banking and reputation issues including risk appetite for environmental, social and ethical (ESE) issues.

The RBS Group Board's oversight of reputational issues is supported by the senior RBS Group-wide Reputational Risk Forum (RRF) which opines on cases that represent a material reputational risk to the whole organisation. The RRF, which has delegated authority from the Executive Risk Forum, also acts as a central forum to review thematic issues and risk appetite positions. Business franchises also have in place reputational risk approval fora to deliberate on customers, transactions, products or issues that may present a reputational risk for their businesses. An example is the Global Reputational Risk Committee in CIB.

Risk appetite

The Reputational and ESE Risk management team assists business franchises, as well as other control functions, to articulate risk appetite to manage reputational risk. Risk appetite positions for certain issues or markets, for example tax or money remitters, are developed through conducting research on legislation, regulation and potential reputational risk factors, undertaking peer analysis and engaging with internal and external stakeholders to discuss the issues. The risk appetite positions classify risks associated with a particular area into Normal, Sensitive and Prohibited. Customers or transactions designated Sensitive require enhanced due diligence and escalation to a reputational risk forum or individual while those rated Normal can be approved by the business without additional escalation. The team also helps set risk appetite to manage reputational risk related to business engagements and customer relationships in some sensitive industry sectors, such as mining and defence, through the ESE policy framework.

A Reputational Risk Policy has also been developed to help employees, businesses and functions effectively identify, assess and manage issues that potentially represent a reputational risk. In addition, other policies, such as those related to conduct, address key sources of reputational risk. These policies are implemented in accordance with the Policy Framework through business and functional policy standard owners. The effectiveness of these policies within each franchise is reported on through the Control Environment Certification process (Refer to the Operational risk section on page 36). Reputational aspects also form a core part of the RBS Group conduct risk framework, with a series of enhanced policies developed in line with conduct risk appetite.

Risk monitoring and measurement
Emerging reputational issues are identified by the business and relevant teams, including RBS Group Sustainability and Enterprise Wide Risk, which assess new and emerging business, sector and country risks for RBS Group. The Risk Management Monthly Report, provided to the Executive Committee and BRC, may also discuss reputational risks facing RBS Group, and the annual Sustainability Report covers progress on sustainability principles.

ESE ratings of customers and transactions are captured and analysed centrally by the Reputational and ESE Risk Team.

Risk mitigation
Reputational risk is mitigated through governance frameworks and training of staff to ensure early identification, assessment and escalation of customers, transactions or products with potential reputational risk, if appropriate. This includes creating appropriate fora, for example reputational risk committees or individual reputational risk approvers.

Also important is the setting of clear reputational risk appetite criteria, ensuring higher risk cases are escalated for senior level approval. Effective communication channels and incident response planning also ensure that cases that result in reputational impact are appropriately managed, for example by declining or exiting business or by ensuring incident management plans are implemented to manage the impact of negative media coverage.

*unaudited

Financial review Capital and risk management

Capital management

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Financial review Capital and risk management

Capital management*

Definition

RBS Group aims to maintain an appropriate level of capital to meet its business needs and regulatory requirements, and operates within an agreed risk appetite. The appropriate level of capital is determined based on the dual aims of: (i) meeting minimum regulatory capital requirements; and (ii) ensuring RBS Group maintains sufficient capital to uphold customer, investor and rating agency confidence in the organisation, thereby supporting its business franchises and funding capacity.

2014 overview

RBSH Group's Tier 1 ratio of 24.5% is higher than the end of 2013 primarily reflecting disposals of liquidity portfolio and the transfer of the Thailand entity to RBS plc. There were also further reductions in the RCR portfolio. In the second half of 2014 RBS Group paid down their Tier 2 capital to RBS N.V. of €2.5 billion and there was a dividend upstream of €300 million from RBS N.V. via RBSH Group to RBS Group. The Tier 2 capital was treated as a full capital deduction under the Capital Requirements Directive IV (CRD IV) rules.

Regulatory developments

Capital requirements regulation and directive

The European Union has implemented the Basel III proposals and a number of important changes to the banking regulatory framework through the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD) collectively known as the CRD IV package. The CRD IV package was implemented on 1 January 2014 with full implementation to be completed on 1 January 2019. As part of the implementation of the CRD IV package, the European Banking Authority's technical standards, which are legal acts specifying particular aspects of the CRD IV package, are either in progress to be finalised through adoption by the European Commission or now adopted.

The CRD IV package continues to require a total amount of capital equal to at least 8% of risk-weighted assets but the share that has to be of the highest quality, that is Common Equity Tier 1 capital, increased from 2% to 4.5%. The CRD IV package also introduces more stringent criteria for capital instruments, harmonised adjustments made to capital recognised for regulatory purposes and establishes new capital buffers to be phased in from 1 January 2014. Once fully implemented on 1 January 2019 the following minimum requirements must be met:

- Pillar 1 requirement of: CET1 of 4.5% of RWAs; Tier 1 of 6%; and total capital of 8%.

- Capital buffers: 'capital conservation buffer' of 2.5% of RWAs; 'countercyclical capital buffer' of up to 2.5%; 'Global-Systemically Important Bank (G-SIB)' surcharge of 1.5%; an 'other systemically important institutions buffer' for domestically or EU important institutions and if required by a member state an additional 'systemic risk buffer.

- Minimum Tier 1 leverage ratio of 3%.

RBSH Group is managing the changes to capital requirements from new regulation (including model changes) and the resulting impact on the Common Equity Tier 1 ratio alongside its strategy of risk reduction and deleveraging. This is principally being achieved through the transfers/sales of countries and businesses to RBS plc and other interested parties, the continued run-off and disposal of RCR assets and deleveraging in CIB businesses.

The overall impacts of the regulatory changes are fully factored into the capital plans of RBSH Group and its businesses.

Banking Union: Single Supervisory Mechanism

On 15 October 2013, the EU Council formally adopted the Regulation on the Single Supervisory Mechanism (SSM) which became operational on 4 November 2014. The SSM is a new framework for banking supervision in Europe with the aims of ensuring the safety and soundness of the European banking system and increasing financial integration and stability in Europe.

The European Central Bank has to ensure that credit institutions not only meet the minimum prudential capital requirements set by the CRR/CRD IV but also have an additional buffer reflecting their individual intrinsic risk profile. This is organised through the SSM. The SSM has to ensure that credit institutions have sufficient capital to cover unexpected losses or survive severe stressed economic and market conditions. The joint capital decision is the key outcome of the Supervisory Review and Evaluation Process. In this process, the supervisor reviews the governance and internal control arrangements used by each individual bank to manage its risks (i.e. the Internal Capital Adequacy Assessment Process).

Overall this framework governs relations between the European Central Bank (ECB), national supervisors and banks and is an important step towards banking union in the EU.

Starting late in 2013 and prior to the adoption of the SSM on 4 November 2014 a comprehensive assessment of significant banks in the euro area (including RBSH Group) was conducted by the ECB. RBSH Group successfully passed the comprehensive assessment which was a rigorous “financial health check” that included a comprehensive risk assessment, a detailed asset quality review and a stress test. The results of the comprehensive assessment were made public by the ECB in October 2014.

Governance and approach

RBSH Group Asset and Liability Management Committee (ALCo) is responsible for ensuring RBSH Group maintains adequate capital at all times. The ALCo manages and plans RBSH Group capital levels taking into account current and projected capital levels and provides input to and oversees capital levels agreed in the annual Internal Capital Adequacy Assessment Process (ICAAP).

ALCo also plans and manages capital interaction with RBS Group. Such interaction would include, amongst other matters, ALCo considerations around RBSH Group’s strategic asset sales/transfers to RBS Group which would need to be capital neutral to RBS Group and are required to be structured in such way so as to satisfy DNB, ECB and PRA regulatory requirements. The ALCo is in turn ultimately governed by RBSH Group’s Managing Board who approve both ALCo and ICAAP capital management decisions.

*unaudited

Determining appropriate capital
RBSH Group aims to maintain an appropriate level of capital to meet its business needs (which include requirements of its parent company RBS Group) and its regulatory requirements and to operate within an agreed risk appetite. Determination of appropriate capital levels involves regular ALCo capital monitoring and planning, budgeting cycle forecasts, and an annual ICAAP. Capital plans are subjected to governance reviews, Managing Board oversight and approval and the review by the appropriate supervisory authority.

Through the annual ICAAP process, RBSH Group makes a determination of its desired capital levels based on maintaining a target external credit rating and risk appetite within both current and emerging regulatory requirements . Desired capital levels are evaluated through the application of both internally and externally defined stress tests that quantify changes in capital ratios under a range of scenarios. The stress tests are also used to identify management and recovery actions that RBSH Group would expect to implement should such eventualities arise. These stress assessments are a key part of capital management and contingency planning and therefore complement agreed capital buffers.

Monitoring and maintenance
RBSH Group operates a rigorous capital planning process via ALCo aimed at ensuring the capital position is controlled within the agreed parameters. This incorporates regular re-forecasts of the capital position of the RBSH Group. In the event that the projected position deteriorates beyond acceptable levels, RBSH Group would revise business plans accordingly. RBSH Group is managing the changes to capital requirements from new regulation and model changes and the resulting impact on the Common Equity Tier 1 ratio, focusing on risk reduction and deleveraging. This is principally being achieved through the transfers to RBS plc, the continued run-off and disposal of RCR assets and deleveraging in CIB as the business focuses on the most productive returns on capital.

The overall impacts of the regulatory changes are fully factored into the capital plans of RBSH Group and its businesses.

Capital allocation
Capital resources are allocated to RBSH Group's businesses based on both key performance parameters agreed by the RBS Group Board in an annual strategic planning process and the requirements of strategic asset transfer programmes and capital allocation requirements determined in consultation with RBS Group.

RBSH Group has regard to the supervisory requirements of De Nederlandsche Bank (DNB) and the ECB under the SSM. The DNB/ECB uses the capital ratio as a measure of capital adequacy in the Netherlands and Eurozone banking sector, comparing a bank's capital resources with its RWAs (the assets and off-balance sheet exposures are weighted to reflect the inherent credit and other risks).

*unaudited

Financial review Capital and risk management

Capital management* continued

Capital ratios and risk-weighted assets

RBSH Group aims to maintain an appropriate level of capital to meet its business needs and regulatory requirements. RBSH Group's capital ratios and RWAs are set out below.

	CRR transitional basis	Basel 2.5 basis	
	2014	2013	2012
Capital ratios	%	%	%
Core Tier 1	16.2	20.5	11.7
Tier 1	24.5	23.2	13.9
Total	33.9	26.1	19.8
Risk-weighted assets	€m	€m	€m
Credit risk	18,179	15,094	26,336
Market risk	1,182	1,171	3,389
Operational risk	732	1,088	2,994
Settlement risk	28	32	20
	20,121	17,385	32,739

With effect from 1 January 2014 RBSH Group is regulated under the CRD IV package of Basel 3. The increase in RWAs in 2014 largely reflects the proportional consolidation of Saudi Hollandi Bank, which was previously treated as a capital deduction.

RBSH Group has used the basic indicator approach since 2013 to calculate the operational risk capital charge.

*unaudited

Financial review Capital and risk management

Capital Management continued

Capital resources and flow statement

RBSH Group's regulatory capital resources were as follows:

	2014 CRR transitional basis	2013 Basel 2.5 basis	2012 Basel 2.5 basis
Composition of regulatory capital	€m	€m	€m
Tier 1			
Controlling interests	3,473	2,942	1,799
Adjustment for:			
- Goodwill and other intangible assets	(44)	(1)	(4)
- Unrealised losses on available-for-sale debt securities	54	883	2,492
- Unrealised gains on available-for-sale equities	(7)	(3)	(19)
- Other regulatory adjustments	(225)	(260)	(442)
Core Tier 1 capital	3,251	3,561	3,826
Trust preferred securities	2,686	2,365	2,470
Less deductions from Tier 1 capital	(1,008)	(1,887)	(1,757)
Total Tier 1 capital	4,929	4,039	4,539
Tier 2			
Unrealised gains on available-for-sale equities	—	3	19
Subordinated debt	1,043	1,552	3,218
Additions to/(deductions from) Tier 2 capital	855	(1,061)	(1,303)
Total Tier 2 capital	1,898	494	1,934
Total regulatory capital	6,827	4,533	6,473

The table below analyses the movement in Core Tier 1 capital during the year.

	2014
Movement in Core Tier 1 capital	€m
At 1 January 2014	3,561
Regulatory adjustment: fair value changes in own credit spreads	26
Foreign currency reserves	(78)
Loss of non-controlling interest and reduction in goodwill	(43)
Attributable loss	(100)
Ordinary dividend paid	(300)
Other	185
At 31 December 2014	3,251

*unaudited

Financial review Capital and risk management

Liquidity and funding risk	
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Financial review Capital and risk management

Liquidity and funding risk
Definition
Liquidity and funding risk is the risk that RBSH Group is unable to meet its financial obligations, including financing wholesale maturities or customer deposit withdrawals, as and when they fall due.

The risk arises through the maturity transformation role that banks perform. It is dependent on company specific factors such as maturity profile, composition of sources and uses of funding, the quality and size of the liquidity portfolio as well as broader market factors, such as wholesale market conditions alongside depositor and investor behaviour.

As one of the primary operating entities of the RBS Group, RBSH Group's liquidity risk is monitored and managed centrally by the RBS Group in line with the policies and processes set by the RBSH Group's Managing Board.

Liquidity risk
Policy, framework and governance
Internal liquidity policies are designed to ensure that RBSH Group:

- Has a clearly stated liquidity risk tolerance: appetite for liquidity risk is set by the Board as a percentage of the Individual Liquidity Adequacy Assessment (ILAA) stressed outflows, and is managed on a daily basis by legal entity, country, region and business. In setting risk limits the Board takes into account the nature of RBSH Group various activities, the overall risk appetite, market best practice and regulatory compliance.

- Has in place strategies, polices and practices to ensure that RBSH Group maintains sufficient liquidity: the risk management framework determines the sources of liquidity risk and the steps that can be taken when these risks exceed certain actively monitored limits. These actions include when and how to use the liquid asset portfolio, and what other adjustments to the balance sheet should be undertaken to manage these risks within the bank's risk appetite. RBSH Group maintains an adequate liquid asset portfolio appropriate to the business activities of RBSH Group and its risk profile.

- Incorporates liquidity costs, benefits and risks in product pricing and performance management: RBSH Group uses internal funds transfer pricing to ensure that these costs are reflected in the measurement of business performance and to correctly incentivise businesses to source the most appropriate mix of funding.

The Asset and Liability Management Committee (ALCo) sets and reviews the liquidity risk management framework and limits within the risk appetite set by the Managing Board. ALCo oversees the implementation of liquidity management across RBSH Group.

In setting risk limits the RBSH Group Board takes into account the nature of the RBSH Group's various activities, the RBSH Group's overall risk appetite and regulatory compliance.

Regulatory oversight*
With effect from November 2014, RBSH Group is subject to the European Central Bank's (ECB), supervisory regime for liquidity and each member of RBSH Group also complies with their local regulatory framework for the assessment and management of liquidity risk as well as meeting internal standards.

Measurement and monitoring
In implementing the RBSH Group's liquidity risk management framework, a suite of tools are used to monitor, limit and stress test the risks within the balance sheet. The limits control the amount and composition of funding sources,

asset and liability mismatches and funding concentrations, in addition to the level of liquidity risk.

Monitoring, reporting and internal limits are under regular review, given the need to appropriately represent and control the business through its considerable changes over time.

RBSH Group maintains a Contingency Funding Plan (CFP), which forms the basis of analysis and management actions to be undertaken in a liquidity stress. The CFP is linked to stress test results and forms the foundation for liquidity risk limits. The CFP sets out the circumstances under which the plan would be invoked; this includes material worsening of early warning indicators. It also prescribes a communications plan, roles and responsibilities, as well as potential management actions to take in response to various levels of liquidity stress. RBSH Group’s CFP is fully integrated with the CFP of RBS Group.

Liquidity reserves
RBSH Group’s liquidity portfolio is managed centrally by RBS Group’s Treasury. In addition, local liquidity reserves are the responsibility of local Treasurers who report to the RBSH Group Treasurer functionally.

Within the liquidity portfolio RBSH Group holds cash at central banks (€0.8 billion) and high quality government securities (€1.8 billion).

During 2014 the RBSH Group undertook an exercise to sell c.€9bn of less-liquid legacy securities to de-risk the balance sheet and take advantage of favourable market conditions.

Funding risk
Funding markets
As part of the reduction in RBSH Group’s balance sheet, funding is now concentrated with RBS Group, who given their active role in the money markets, and access to a broad funding base, provide funding to ensure RBSH Group’s funding is sufficiently diversified.

RBSH Group accesses the wholesale funding markets directly or through its main operating subsidiaries via established funding programmes. The use of different entities to access the market from time to time allows RBSH Group to further diversify its funding mix and in certain limited circumstances demonstrate to regulators that specific operating subsidiaries have market access in their own right.

*unaudited

Financial review Capital and risk management

Funding sources
The table below shows RBSH Group's primary funding sources excluding repurchase agreements.

	2014		2013		2012	
	€m	%	€m	%	€m	%
Deposits by banks	4,542	33.4	7,233	41.0	21,841	64.4
Debt securities in issue						
Commercial paper and certificates of deposit	—	—	—	—	116	0.3
Medium-term notes and other bonds (including securitisations)	1,017	7.5	1,319	7.5	2,486	7.4
	1,017	7.5	1,319	7.5	2,602	7.7
Subordinated liabilities	5,104	37.5	4,951	28.1	6,851	20.2
Wholesale funding	10,663	78.4	13,503	76.6	31,294	92.3
Customer deposits	2,933	21.6	4,118	23.4	2,620	7.7
Total funding	13,596	100	17,621	100	33,914	100

*unaudited

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Credit risk

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Credit risk

Risk management is conducted on an overall basis within RBS Group. Therefore the discussion on pages 49 to 56 refer principally to policies and procedures in RBS Group that also apply to RBSH Group.

Definition

Credit risk is the risk of financial loss due to the failure of a customer or counterparty to meet its obligation to settle outstanding amounts.

Sources of credit risk

The RBSH Group is exposed to credit risk through wholesale lending, derivatives and through off-balance-sheet products such as trade finance and guarantees. The RBSH Group is also exposed to credit risk as a result of debt securities held for liquidity management purposes.

Risk governance

The potential for loss is mitigated through a robust credit risk culture and a focus on sustainable lending practices.

Operating model

The RBS Group credit risk management function, which is led by the Group Chief Credit Officer (GCCO), acts as the ultimate authority for the approval of credit and is responsible for ensuring that credit risk is within the risk appetite set by the RBS Group Board. The function is also responsible for managing concentration risk and credit risk control frameworks as well as developing and ensuring compliance with credit risk policies. In addition, the function conducts RBS Group-wide assessments of provision adequacy.

Credit risk within RBSH Group is managed by the RBS Group credit risk function through an RBSH Group credit risk delegate who reports to the GCCO and has a functional line to the RBSH Group CRO. RBSH Group credit risk management activities include credit risk appetite setting, transaction and portfolio analysis, and ongoing credit risk monitoring and oversight.

The Executive Risk Forum (ERF) has delegated approval authority to the Credit Risk Committee (CRC) to act on credit risk matters. These include, but are not limited to, credit risk appetite and limits (within the overall risk appetite set by the RBS Group Board and the ERF), credit risk strategy and frameworks, credit risk policy and the oversight of the credit profile across RBS Group. There are separate CRCs for the wholesale and personal portfolios. These are chaired by the GCCO or delegate.

The ERF has delegated approval authority to the RBS Group Provisions Committee to manage provisions adequacy, both individual and collective. The RBS Group Provisions Committee, which is chaired by either the Chief Risk Officer or the GCCO, approves recommendations from lower-level provisions committees, which in turn have delegated approval thresholds for certain provision adequacy decisions.

Key trends in the credit risk profile of RBSH Group, performance against limits and emerging risks are set out in the Risk Report provided to the RBSH Group Risk Controls Committee (RCC) and the Supervisory Board.

The Risk Infrastructure function provides a variety of services that enable the credit risk management function to operate. These include reporting of credit risk data, risk assurance, provision of credit risk models, systems strategy and change management.

Controls and assurance

The RBS Group credit control and assurance framework has three key components: credit policy, policy compliance assessment and independent assurance. These apply to both wholesale and personal credit risk at both portfolio and individual customer level.

The first component is the RBS Group Credit Policy Standard, which is part of the RBS Group Policy Framework. It sets out the rules that must be followed to ensure that credit risks are identified and effectively managed through the credit lifecycle.

The second component is a policy compliance assessment activity that credit risk undertakes to provide the GCCO with evidence of the effectiveness of credit risk management controls in place across RBS Group. The results of these reviews support the self-certification that credit risk must complete every six months.

The third component of RBS Group credit assurance framework is the credit quality assurance activity carried out independently by Risk Assurance, which is part of the Risk Infrastructure function. Risk Assurance independently reviews lending activities to identify control breaches, assess portfolio quality and recommend process improvements. These findings are escalated to senior management and plans to address shortcomings are recorded and tracked in RBS Group’s operational risk system. Risk Assurance’s credit quality assurance activities are overseen by the RBS Group Audit Committee and the results of its reviews are regularly shared with the regulators.

In addition, controls and processes are regularly reviewed by RBS Group’s Internal Audit (IA) function. IA provides assurance to the Group Audit Committee and senior executive that the main business risks have been identified and that effective controls are in place to manage these risks.

Risk management*

Risk appetite

Risk appetite across all risk types is set by RBS Group using specific quantitative targets under stress, including earnings volatility and capital adequacy. The credit risk appetite framework has been designed to reflect the factors that influence the ability to meet those targets. These include product and asset class, industry sector, single name and country concentrations. Any of these factors could generate higher earnings volatility under stress and, if not adequately controlled, undermine capital adequacy. Tools such as stress testing and economic capital are used to measure credit risk volatility and develop links between risk appetite targets and the credit risk appetite framework. The frameworks are supported by a suite of policies that set out the risk parameters within which franchises must operate. Impairments, and associated key metrics such as loan loss rates and provision coverage, are an integral part of standard credit risk portfolio reviews and are presented to CRC monthly. These metrics are also fully considered as part of the sector and product class appetite reviews. RBS Group also manages its exposures to counterparty credit risk closely, using portfolio limits and specific tools to control more volatile or capital-intensive business areas.

*unaudited

Risk monitoring and problem debt management
A key aspect of credit risk management relates to problem debt management, from early problem identification through to litigation and recovery of cash when there is no realistic potential for rehabilitation. Various tools and techniques are deployed during this part of the credit cycle including the offering of forbearance. For further information refer to the Wholesale credit risk management sub-section.

Impairments and write-offs
Internal measures of credit risk are stated gross of impairments. However, impairments and write-offs are used as key indicators of credit quality as part of the overall assessment of credit risk incurred by RBS Group. These are estimated as follows:

Impaired definition
A financial asset is impaired if there is objective evidence that an event or events since initial recognition of the asset has adversely affected the amount or timing of future cash flows from it. The loss is measured as the difference between the carrying value of the asset and the present value of estimated future cash flows discounted at the original effective interest rate.

For wholesale exposures, days-past-due measures are typically used to identify evidence of impairment. In corporate portfolios, a period of 90 days past due is used. In sovereign portfolios, the period used is 180 days past due. Other factors are considered including: the borrower's financial condition; a forbearance event; a loan restructuring; the probability of bankruptcy; or any evidence of diminished cash flows.

Provisioning
If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the asset carrying amount and the present value of the estimated future cash flows discounted at the financial asset's original effective interest rate. The current net realisable value of the collateral will be taken into account in determining the need for a provision. This includes cash flows that may result from foreclosure less the costs of obtaining and selling the collateral, whether or not foreclosure is probable. No impairment provision is recognised in cases where amounts due are expected to be settled in full on realisation of the security. RBSH Group uses primarily one of the following two different methods to assess the amount of provision required: individual; and latent.

Individually-assessed provisions
Loans and securities above a defined threshold deemed to be individually significant are assessed on a case-by-case basis. Assessments of future cash flows take into account the impact of any guarantees or collateral held. Estimating the amount and timing of future cash flows involves judgement based on the facts available at the time and assumptions related to the future financial performance of the customer or counterparty and any guarantors as well as future economic conditions and the value of collateral. Projected cash flows are reviewed on subsequent assessment dates as new information becomes available.

Latent loss provisions
In the performing portfolio, latent loss provisions are held against losses incurred but not identified before the balance sheet date. Latent loss provisions reflect probability of default (PD) and loss given default (LGD) as well as emergence periods. The emergence period is the period between the occurrence of the impairment event and the identification and reporting of a loan as impaired.

Emergence periods are estimated at a portfolio level and reflect the portfolio product characteristics such as coupon period and repayment terms, and the duration of the administrative process required to report and identify an impaired loan as such. Emergence periods in RBSH Group vary across different portfolios from 150 days for non-forborne exposures to 365 days for forborne exposures. They are based on actual experience within the particular portfolio and are reviewed regularly.

Latent provisions are computed by applying portfolio-level LGDs, PDs and emergence periods. The wholesale calculation is based on similar principles but there is no segmentation into portfolios. PDs and LGDs are calculated individually.

*unaudited

Available-for-sale portfolios
RBSH Group reviews its portfolios of available-for-sale financial assets for evidence of impairment, which includes: default or delinquency in interest or principal payments; significant financial difficulty of the issuer or obligor; and increased likelihood that the issuer will enter bankruptcy or other financial reorganisation. However, the disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. Furthermore, a downgrade of an entity's credit rating is not, in itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment. Determining whether evidence of impairment exists requires the exercise of management judgement. Unrecognised losses on RBSH Group's available-for-sale debt securities are concentrated in its portfolios of asset-backed securities. Such losses reflect the widening of credit spreads as a result of the reduced market liquidity in these securities and the current uncertain macroeconomic outlook in Europe. The underlying securities remain unimpaired. See also the AFS analysis table on page 63.

Sensitivity of impairments to assumptions
Key assumptions relating to impairment levels of secured lending relate to the valuation of the security and collateral held, the timing of asset disposals based on the underlying market depth and liquidity and customer cooperation. Assumptions on timing also include an assessment of the ease and timing of the enforceability of loan agreements in varying legal jurisdictions. Assumptions are made on a case by case basis in the case of individually assessed provisions and are often based on judgement.

Key assumptions relating to impairment levels of unsecured lending relate to economic conditions and the interest rate environment, which have a direct impact on customers' debt servicing capabilities. For individual impairments greater than £1 million, oversight is provided by the RBS Group Provisions Committee.

Write-offs
Impaired loans and receivables are written-off, that is, the impairment provision is applied in writing down the loan's carrying value partially or in full, when 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-offs may be prompted by bankruptcy, insolvency, forbearance and similar events.

Risk measurement*
Risk exposure measurement
RBSH Group uses a range of measures for credit risk exposures. The internal measure used, unless otherwise stated, is credit risk assets (CRA) consisting of:

- Lending exposure - measured using drawn balances and includes cash balances at central banks and loans and advances to banks and customers (including overdraft facilities, instalment credit and finance leases).

- Counterparty exposures - measured using the marked-to-market value of derivatives after the effect of enforceable netting agreements and regulator-approved models but before the effect of collateral. Counterparty exposures include rate risk management, which includes those arising from foreign exchange transactions, interest rate swaps, credit default swaps and options.

- Contingent obligations - measured using the value of the committed amount and including primarily letters of credit and guarantees.

CRA exclude issuer risk (primarily debt securities) and securities financing transactions. CRA take account of regulatory netting although, in practice, obligations are settled under legal netting arrangements that provide a right of legal set-off but do not meet the offset criteria under IFRS.

Risk models
RBS Group uses the output of credit risk models in the credit approval process -as well as for ongoing credit risk assessment, monitoring and reporting - to inform credit risk appetite decisions. These models may be divided into three categories:

Probability of default (PD)
PD models assess the probability of a customer failing its credit obligations over a one-year period.

- Wholesale models - A number of credit grading models consider risk characteristics relevant to different customer types. These models use a combination of quantitative inputs, such as recent financial performance, and qualitative inputs such as management performance or sector outlook. As part of the credit assessment process, RBS Group assigns each customer an internal credit grade based on its PD.

Exposure at default (EAD)
EAD models 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. Regulatory requirements stipulate that EAD must always be equal to, or higher, than current utilisation. Exposure can be reduced by a legally enforceable netting agreement.

*unaudited

Loss given default (LGD)
LGD models estimate the amount that cannot be recovered in the event of customer default. When estimating LGD, RBS Group's models assess both borrower and facility characteristics, as well as any credit risk mitigants. The cost of collections and a time-discount factor for the delay in cash recovery are also incorporated.

Changes to credit models
RBS Group reviews and updates models on an ongoing basis, reflecting the impact of more recent data, changes to products and portfolios, and new regulatory requirements. Extensive changes were made to wholesale models in 2012 and 2013. This continued in 2014 with further changes, notably in the corporate exposure class.

New PD models are being implemented for large corporate customers. The roll-out will be completed by mid-2015. The updated calibrations associated with these new models, which reference over 20 years of rating agency default experience, may result in downwards rating migrations across internal asset quality bands. For further information regarding the impact of this change refer to the Asset quality section on page 59.

Economic capital
The credit economic capital model is a framework that allows for the calculation of portfolio credit loss distributions and associated metrics over a given risk horizon for a variety of business purposes.

The model takes into account migration risk (the risk that credit assets will deteriorate in credit quality across multiple years), factor correlation (the assumption that groups of obligors share a common factor) and contagion risk (for example, the risk that the weakening of the sovereign's credit worthiness has a significant impact on the creditworthiness of a business operating in that country).

Risk mitigation
Risk mitigation techniques are used in the management of credit portfolios across RBS Group, typically to mitigate credit concentrations in relation to an individual customer, a borrower group or a collection of related borrowers. Where possible, customer credit balances are netted against obligations.

Mitigation tools applied can include: structuring a security interest in a physical or financial asset; use of credit derivatives, including credit default swaps, credit-linked debt instruments and securitisation structures; and use of guarantees and similar instruments (for example, credit insurance) from related and third parties.

When seeking to mitigate risk, at a minimum RBS Group considers the following:

- The suitability of the proposed risk mitigation, particularly if restrictions apply;
- The means by which legal certainty is to be established, including required documentation, supportive legal opinions and the steps needed to establish legal rights;
- The acceptability of the methodologies to be used for initial and subsequent valuation of collateral, the frequency of valuations and the advance rates given;
- The actions which can be taken if the value of collateral or other mitigants is less than needed;
- The risk that the value of mitigants and counterparty credit quality may deteriorate simultaneously;

- The need to manage concentration risks arising from collateral types; and
- The need to ensure that any risk mitigation remains legally effective and enforceable.

The RBS Group business and credit teams are supported by specialist in-house documentation teams. RBS Group uses industry-standard loan and security documentation wherever possible. However, when non-standard documentation is used, external lawyers are employed to review it on a case-by-case basis. For further information refer to the Wholesale credit risk management sub-section.

Wholesale credit risk management
Wholesale credit risk management focuses on the credit risks arising from activities with corporate and SME clients as well as banks, other financial institutions and sovereigns.

Risk appetite frameworks
Four formal frameworks are used to manage wholesale credit concentration risk. RBS Group continually reassesses its frameworks to ensure they remain appropriate for its varied business franchises and current economic conditions as well as to reflect further refinements in RBS Group’s risk measurement models.

Through the overlay model, RBSH Group’s concentration risks are captured in and primarily governed by, the RBS Group’s risk control frameworks. However, concentration risks are actively monitored from an RBSH Group perspective through monthly reporting and appropriate action is taken if necessary.

Single name concentration
A single name concentration (SNC) framework addresses the risk of outsized loss arising from a concentration of credit risk to a single borrower or borrower group. The framework includes elevated approval authority, additional reporting and monitoring, and the requirement for plans to address exposures in excess of appetite.

*unaudited

SNC excesses are reviewed on a gross basis as well as on a net basis after taking mitigation into account. All net excesses are managed through an approved, customer specific, exposure management plan. To reduce its SNC exposures, RBS Group may decide to sell excess amounts or rely on mitigation. To be considered effective under the framework, mitigation must be "eligible". Examples of eligible credit risk mitigants include cash collateral, government or bank guarantees, credit default swaps or trade insurance. Eligible credit risk mitigants must also be structurally effective, legally certain, enforceable and characterised by an appropriate maturity profile.

Sector concentration

Sector concentration risk is the risk of an outsized loss arising from a concentration of credit risk to customers in the same sector or across sectors that are susceptible to similar stress events. The sector concentration framework enables RBS Group to manage this risk and acts as one of the primary mechanisms for cascading the RBS Group Board-approved risk appetite to business franchises. It also details the controls for managing and reporting credit exposure to industry sectors.

The sector concentration framework was revised in 2014. Previously, sectors were classified according to size. Under the revised sector framework, sectors are classified according to their risk (based on EC and various qualitative factors) as well as size. This classification drives the level of oversight and frequency of sector reviews. Reviews may include an assessment of business strategy, credit risk profile, key risks and mitigants, the current and expected future external environment, vulnerability to stress events, regulatory developments and economic capital usage to derive a proposed risk appetite along with transaction acceptance standards.

Product and asset class concentration framework

Product and asset class concentration risk is the risk of an outsized loss arising from a concentration in certain products or asset classes. The product and asset class framework monitors specific credit risk types such as settlement or wrong-way risk and products such as long-dated derivatives or securitisations. These product and asset classes may require specific policies and expertise as well as tailored monitoring and reporting measures. In some cases specific limits and thresholds are deployed to ensure that the credit risk inherent in these lines of business and products is adequately controlled. Exposures are reviewed regularly in accordance with the product and asset class concentration framework. The reviews consider the risks inherent in each product or asset class, the risk controls applied, monitoring and reporting of the risk, the client base, and any emerging risks to ensure risk appetite remains appropriate.

Country concentration

The country concentration framework is described in the Country risk section on pages 72 to 77.

Risk assessment

The credit risk function assesses, approves and manages the credit risk associated with a borrower or group of related borrowers.

The Group Chief Credit Officer has established a framework of individual delegated authorities, which are set out in the RBS Group Credit Risk Policy. The framework requires at least two individuals to approve each credit decision, one from the business and one from the credit risk function. Both must hold appropriate delegated authority, which is dependent on their experience and expertise. Only a small number of senior executives hold the highest authority provided under the framework. While both parties are accountable for the quality of each decision taken, the credit risk approver holds ultimate sanctioning authority.

Assessments of credit risk must, at a minimum, specifically address the following elements:

- The amount, terms, tenor, structure, conditions, purpose and appropriateness of all credit facilities;
- Compliance with applicable RBS Group-wide and/or franchise-level credit policies;
- The customer's ability to meet obligations, based on an analysis of financial information and a review of payment and covenant compliance history;
- The source of repayment and the customer's risk profile, including its sector and sensitivity to economic and market developments, and any credit risk mitigation;
- Refinancing risk - the risk of loss arising from the failure of a customer to settle an obligation on expiry of a facility through the drawdown of another credit facility provided by RBSH Group or by another lender;
- Consideration of other risks such as environmental, social and ethical, regulatory and reputational risks; and
- The portfolio impact of the transaction, including the impact on any credit risk concentration limits or agreed business franchise risk appetite.

At a minimum, credit relationships are reviewed and re-approved annually. The renewal process addresses borrower performance, including reconfirmation or adjustment of risk parameter estimates; the adequacy of security; compliance with terms and conditions; and refinancing risk.

Risk mitigation
RBS Group mitigates credit risk through the use of netting, collateral and the use of market standard documentation.

The types of collateral RBS Group takes to mitigate the credit risk arising from wholesale lending varies according to the nature of the counterparty and its assets. The most common types are:

- Physical assets - These may include stock, plant, equipment, machinery, vehicles, ships and aircraft. Such assets are suitable collateral only if RBS Group can identify, locate, and segregate them from other assets on which it does not have a claim. RBS Group values physical assets in a variety of different ways, depending on the type of asset concerned and may rely on balance sheet valuations in certain cases.

- Receivables - These are amounts owed to RBS Group's counterparties by their own customers. RBS Group values them after taking into account the quality of its counterparty's receivable management processes and excluding any that are past due.

All collateral is assessed case-by-case to ensure that it will retain its value independently of the provider. RBS Group monitors the value of the collateral and, if there is a shortfall, will seek additional collateral.

Problem debt management
Early problem identification
Each segment has defined early warning indicators (EWIs) to identify customers experiencing financial difficulty, and to increase monitoring if needed. EWIs may be internal, such as a customer's bank account activity, or external, such as a publicly-listed customer's share price. If EWIs show a customer is experiencing potential or actual difficulty, credit officers within the business franchise may decide to place the customer on the Watchlist.

Watchlist*
For customers not managed in RCR, there are three Watch classifications - Amber, Red and Black - reflecting progressively deteriorating conditions. Watch Amber customers are performing customers who show early signs of potential financial difficulty, or have other characteristics that warrant closer monitoring. Watch Red customers are performing customers who show signs of declining creditworthiness and so require active management usually by Restructuring (formerly known as Global Restructuring Group). The Watch Black portfolio includes AQ10 exposures.

Once on the Watchlist, depending on the severity of the financial difficulty and the size of the exposure, the customer relationship strategy is reassessed by credit officers, by specialist credit risk or relationship management units in the relevant business or by Restructuring. In accordance with RBS Group-wide policies, a number of mandatory actions are taken, including a review of the customer's credit grade and facility and security documentation.

In more material cases, a forum of experienced credit, portfolio management and remedial management specialists in either the relevant business or Restructuring may reassess the customer relationship strategy.

Appropriate corrective action is taken when circumstances emerge that may affect the customer's ability to service its debt. Such circumstances include deteriorating trading performance, imminent breach of covenant, challenging macroeconomic conditions, a late payment or the expectation of a missed payment.

For all Watch Red cases, credit specialists in the relevant business are required to consult with their counterparts in Restructuring on whether the relationship should be transferred to Restructuring (for more information on Restructuring, refer to the section below). Watch Red customers that continue to be managed by the business tend to be those requiring subject matter expertise that is available in the business rather than in Restructuring.

Remediation strategies available in the business include granting a customer various types of concessions. Any decision to approve a concession will be a function of specific country and sector appetite, the credit quality of the customer, the market environment and the loan structure and security. For further information, refer to the Forbearance section below.

Other potential outcomes of the relationship review are to: take the customer off the Watchlist; offer additional lending and continue monitoring; transfer the relationship to Restructuring if appropriate; or exit the relationship altogether.

Customers managed in RCR are by their nature subject to heightened scrutiny and regular review against specific disposal plans. RCR customers are separately identified in RBS Group’s internal Watchlist reporting, with their Watchlist classification based on asset quality.

Restructuring

Separately to the Credit Risk management function, the Restructuring team manages RBS Group’s wholesale problem debt portfolio in cases where its exposure to the customer exceeds £1 million. In addition, Restructuring has a specialist credit function, the Strategy Management Unit, for distressed bilateral lending where the exposure is between £250,000 and £1 million.

The factor common to all customers managed by Restructuring is that RBS Group’s exposure is outside risk appetite. The primary function of Restructuring is to restore customers to an acceptable credit profile, minimise losses to RBS Group and protect RBS Group’s capital.

Specialists in Restructuring work with customers experiencing financial difficulties, and showing signs of financial stress, with the aim of restoring their business to financial health whenever possible. The objective is to find a mutually acceptable solution, including repayment, refinancing or transfer to another bank if that is the customer’s preferred option.

*unaudited

The specialists conduct a detailed assessment of the viability of the business, as well as the ability of management to deal with the causes of financial difficulty, focusing on both financial and operational issues. Following the assessment, various options are discussed with the customer (which may involve debt restructuring or forbearance or both) and bespoke solutions are developed.

If the customer's finances are not viable and a mutually agreed exit is not possible, insolvency may be considered as a last resort. However, helping the customer return to financial health and restoring a normal banking relationship is always the desired goal.

Forbearance

Definition

Forbearance takes place when a concession is made on the contractual terms of a loan in response to a customer's financial difficulties.

Concessions granted where there is no evidence of financial difficulty, or where any changes to terms and conditions are within usual risk appetite (for a new customer), or reflect improving credit market conditions for the customer, are not considered forbearance.

A number of options are available. These are tailored to the customer's individual circumstances. The aim is to restore the customer to financial health and to minimise risk to RBS Group. To ensure that forbearance is appropriate for the needs and financial profile of the customer, RBS Group applies minimum standards when assessing, recording, monitoring and reporting forbearance.

At 31 December 2014, loans totalling €57 million (2013 - €44 million) were subject to forbearance procedures but had not reached legal completion, the forbearance completed in 2014 was €7 million (2013 - nil).

Types of wholesale forbearance

Wholesale forbearance may involve the following types of concessions:

Payment concessions and loan rescheduling, including extensions in contractual maturity, may be granted to improve the customer's liquidity. Concessions may also be granted on the expectation that the customer's liquidity will recover when market conditions improve. In addition, they may be granted if the customer will benefit from access to alternative sources of liquidity, such as an issue of equity capital. These options have been used in CRE transactions, particularly during periods where a shortage of market liquidity has ruled out immediate refinancing and made short-term collateral sales unattractive.

Debt may be forgiven, or exchanged for equity, where the customer's business condition or economic environment is such that it cannot meet obligations and where other forms of forbearance are unlikely to succeed. Debt forgiveness can be used for stressed corporate transactions and are typically structured on the basis of projected cash flows from operational activities, rather than underlying tangible asset values. Provided that the underlying business model, strategy and debt level are viable, maintaining the business as a going concern is the preferred option, rather than realising the value of the underlying assets.

The contractual margin may be amended to bolster the customer's day-to-day liquidity to help sustain its business as a going concern. This would normally be a short-term solution. As set out above, RBS Group would seek to obtain a return commensurate to the risk that it is required to take and this can be structured as set out above.

A temporary covenant waiver, a recalibration of covenants or a covenant amendment may be used to cure a potential or actual covenant breach. In return for this relief, RBS Group would seek to obtain a return commensurate with the risk that it is required to take. The increased return for the increased risk can be structured flexibly to take into account the customer's circumstances. For example it may be structured as either increased margin on a cash or payment in kind basis, deferred return instruments or both. While RBS Group considers these types of concessions qualitatively different from other forms of forbearance, they constitute a significant proportion of wholesale forborne loans and are therefore included in these forbearance disclosures.

Loans may be forborne more than once, generally where a temporary concession has been granted and circumstances warrant another temporary or permanent revision of the loan's terms. All customers are assigned a PD and related facilities a LGD. These are re-assessed prior to finalising any forbearance arrangement in light of the loan's amended terms and any revised grading is incorporated in the calculation of the impairment loss provisions for RBS Group's wholesale exposures. Where forbearance is no longer viable, RBS Group will consider other options such as the enforcement of security, insolvency proceedings or both.

The ultimate outcome of a forbearance strategy is unknown at the time of execution. It is highly dependent on the cooperation of the borrower and the continued existence of a viable business. The following are generally considered to be options of last resort:

- Enforcement of security or otherwise taking control of assets - Where RBS Group holds collateral or other security interest and is entitled to enforce its rights, it may enforce its security or otherwise take control of the assets. The preferred strategy is to consider other possible options prior to exercising these rights.

- Insolvency - Where there is no suitable forbearance option or the business is no longer sustainable, insolvency will be considered. Insolvency may be the only option that ensures that the assets of the business are properly and efficiently distributed to relevant creditors.

Impairments for forbearance
Wholesale loans granted forbearance are individually assessed in most cases and are not therefore segregated into a separate risk pool.

Forbearance may result in the value of the outstanding debt exceeding the present value of the estimated future cash flows. This may result in the recognition of an impairment loss or a write-off.

Provisions for forborne wholesale loans are assessed in accordance with normal provisioning policies. The customer's financial position and prospects as well as the likely effect of the forbearance, including any concessions granted, are considered in order to establish whether an impairment provision is required.

*unaudited

All wholesale customers are assigned a PD and related facilities a LGD. These are re-assessed prior to finalising any forbearance arrangement in light of the loan's amended terms and any revised grading incorporated in the calculation of the impairment loss provisions for RBS Group's wholesale exposures.

For performing loans, credit metrics are an integral part of the latent provision methodology and therefore the impact of covenant concessions will be reflected in the latent provision. For non-performing loans, covenant concessions will be considered in determining the overall provision for these loans.

In the case of non-performing forborne loans, the loan impairment provision assessment almost invariably takes place prior to forbearance being granted. The amount of the loan impairment provision may change once the terms of the forbearance are known, resulting in an additional provision charge or a release of the provision in the period the forbearance is granted.

The transfer of wholesale loans subject to forbearance from impaired to performing status follows assessment by relationship managers and the Credit Risk function in Restructuring. When no further losses are anticipated and the customer is expected to meet the loan's revised terms, any provision is written-off and the balance of the loan returned to performing status. This course of action is not dependent on a specified time period and follows the credit risk manager's assessment that it is appropriate.

Impairments

Impairments in the wholesale portfolio decreased compared with 2013. This reflected a better economic environment as well as an ongoing decrease of the RBSH Group credit portfolio following further transfers of assets to RBS Group.

Watchlist*

The following table shows a sector breakdown of credit risk assets of Watchlist Red counterparties managed by Restructuring.

At 31 December 2014, exposures to customers reported as Watchlist Red and managed by the business totalled €10.0 million (2013 - €10.2 million; 2012 - € 10.6 million).

	2014	2013	2012
Watchlist Red CRA by current exposure	€m	€m	€m
Property	—	2	4
Transport	179	113	212
Retail and leisure	—	8	99
Services	—	1	4
Other	—	198	122
Total	179	322	441

*unaudited

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Balance sheet analysis
Sector and geographic concentration
The analyses in this section is provided to support the discussion on credit risk on pages 48 to 56. All disclosures are audited.

The following tables provide an analysis of the credit concentration of financial assets by sector and geography. Geographical regions are based on the location of the office.

	Loans and advances	Securities	Derivatives	Other (1)	Total
2014	€m	€m	€m	€m	€m
Central and local government	59	2,093	32	—	2,184
Financial institutions (2)	9,227	1,092	4,033	1,174	15,526
Personal	9	—	—	—	9
Corporate	2,177	77	367	1	2,622
Total gross of provisions	11,472	3,262	4,432	1,175	20,341
Provisions	(114)	(19)	—	—	(133)
Total	11,358	3,243	4,432	1,175	20,208
2013					
Central and local government	85	5,937	45	6	6,073
Financial institutions (2)	9,826	9,412	4,385	3,197	26,820
Personal	227	—	—	—	227
Corporate	2,356	246	352	—	2,954
Total gross of provisions	12,494	15,595	4,782	3,203	36,074
Provisions	(195)	(12)	—	—	(207)
Total	12,299	15,583	4,782	3,203	35,867
2012					
Central and local government	891	7,783	55	2	8,731
Financial institutions (2)	16,424	15,347	6,657	2,312	40,740
Personal	283	—	—	—	283
Corporate	4,278	757	843	11	5,889
Total gross of provisions	21,876	23,887	7,555	2,325	55,643
Provisions	(341)	(105)	—	—	(446)
Total	21,535	23,782	7,555	2,325	55,197

Notes:
(1) Includes settlement balances of €40 million (2013 - €10 million; 2012 - €31 million).
(2) Includes reverse repurchase agreements of €1.1 billion (2013 - €0.1 billion; 2012 - €0.1 billion).

Loans and advances to banks and customers by geographical region
The table below analyses loans and advances net of provisions by geographical region (location of office).

	2014	2013	2012
	€m	€m	€m
Loans and advances to banks			
Netherlands	4,048	1,673	3,565
US	—	117	391

Rest of world	3,648	3,905	8,250
	7,696	5,695	12,206
Loans and advances to customers			
Netherlands	645	638	1,518
US	—	37	—
Rest of world	2,894	3,109	4,862
	3,539	3,784	6,380
Balances with ultimate holding company			
Netherlands	123	2,820	2,949
Total	11,358	12,299	21,535

Balance sheet analysis continued

Asset quality

The asset quality analysis presented below is based on RBSH Group's internal asset quality ratings which have ranges for the probability of default, as set out below. 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 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. Debt securities are analysed by external ratings agencies and are therefore excluded from the following table and are set out on page 61.

The following table details, for illustrative purposes only, the relationship between internal asset quality (AQ) bands and external ratings published by 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 (PD) 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.

Asset quality band	Probability of default range	Indicative S&P rating
AQ1	0% - 0.034%	AAA to AA
AQ2	0.034% - 0.048%	AA-
AQ3	0.048% - 0.095%	A+ to A
AQ4	0.095% - 0.381%	A- 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 RBSH Group 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 issuers.

		Loans and advances									
		Banks		Customer							
	Cash and balances at central banks	Derivative cash collateral	Other	Derivative cash collateral	Other	Loans with ultimate holding company	Derivatives	Commitments	Contingent liabilities	Total (1)	Total
2014	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m	%
AQ1	845	104	63	114	413	—	140	52	14	1,745	7.0
AQ2	—	78	254	2	79	—	244	48	1,121	1,826	7.3

AQ3	168	138	477	94	259	—	88	120	4,050	5,394	21.6
AQ4	122	—	373	—	1,315	—	1,387	363	298	3,858	15.4
AQ5	—	—	52	—	458	—	221	136	63	930	3.7
AQ6	—	—	23	—	251	—	85	11	14	384	1.5
AQ7	—	—	70	—	42	—	2	29	23	166	0.7
AQ8	—	—	—	—	24	—	9	8	—	41	0.2
AQ9	—	—	3	—	18	—	—	140	104	265	1.1
AQ10	—	—	—	—	7	—	1	14	—	22	0.1
Balances with RBS Group	—	—	6,061	—	371	123	2,255	—	1,451	10,261	41.1
Past due	—	—	—	—	3	—	—	—	—	3	—
Impaired	—	—	—	—	203	—	—	—	—	203	0.8
Impairment provision	—	—	—	—	(114)	—	—	—	—	(114)	(0.5)
Total	1,135	320	7,376	210	3,329	123	4,432	921	7,138	24,984	100

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Balance sheet analysis continued

		Loans and advances									
		Banks		Customers		Loans with					
	Cash and balances at central banks	Derivative cash collateral	Other	Derivative cash collateral	Other	ultimate holding company	Derivatives	Commitments	Contingent liabilities	Total (1)	Total
2013	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m	%
AQ1	2,907	113	596	116	569	—	573	135	260	5,269	17.7
AQ2	—	120	164	—	204	—	136	14	1,189	1,827	6.2
AQ3	269	434	105	103	546	—	627	288	4,285	6,657	22.4
AQ4	17	80	1,025	58	961	—	825	207	768	3,941	13.3
AQ5	—	57	133	31	322	—	24	135	213	915	3.1
AQ6	—	—	6	—	416	—	9	27	25	483	1.6
AQ7	—	—	—	12	58	—	4	8	10	92	0.3
AQ8	—	—	3	—	44	—	—	15	22	84	0.3
AQ9	—	—	—	—	177	—	6	105	323	611	2.1
AQ10	—	—	—	—	9	—	10	38	—	57	0.2
Balances with RBS Group	—	—	2,859	—	42	2,820	2,568	—	1,361	9,650	32.5
Impaired	—	—	1	—	310	—	—	—	—	311	1.0
Impairment provision	—	—	(1)	—	(194)	—	—	—	—	(195)	(0.7)
Total	3,193	804	4,891	320	3,464	2,820	4,782	972	8,456	29,702	100
2012											
AQ1	2,068	737	964	246	1,145	—	330	1,486	6,276	13,252	27.5
AQ2	—	264	6	—	192	—	577	1,321	431	2,791	5.8
AQ3	226	119	97	143	860	—	175	1,154	966	3,740	7.8
AQ4	—	310	334	40	1,713	—	1,365	802	695	5,259	10.9
AQ5	—	80	173	27	553	—	401	184	218	1,636	3.4
AQ6	—	—	1	—	839	—	11	103	135	1,089	2.3
AQ7	—	—	140	—	201	—	12	68	112	533	1.1
AQ8	—	—	26	—	79	—	31	43	8	187	0.4
AQ9	—	—	17	—	138	—	1	273	500	929	1.9
AQ10	—	—	—	—	27	—	28	35	1	91	0.2
Balances with RBS Group	—	—	8,938	—	—	2,949	4,624	237	1,737	18,485	38.4
Past due	—	—	—	—	12	—	—	—	—	12	—
Impaired	—	—	—	—	506	—	—	—	—	506	1.0

Impairment provision	—	—	—	—	(341)	—	—	—	—	(341)	(0.7)
Total	2,294	1,510	10,696	456	5,924	2,949	7,555	5,706	11,079	48,169	100

Note:
(1) Excludes settlement balances in 2014 of €40 million (2013 - €10 million, 2012 - €31 million).

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Debt securities

The table below analyses debt securities by issuer and external ratings. Ratings are based on the lowest of Standard and Poor's, Moody's and Fitch.

2014	Central and local government €m	Banks €m	Other financial institutions €m	Corporate €m	Total €m	Total %	Of which ABS (1) €m
AAA	48	—	—	16	64	2.1	—
AA to AA+	462	—	92	—	554	18.6	—
A to AA-	700	164	154	—	1,018	34.1	154
BBB- to A-	811	—	—	133	944	31.7	—
Non-investment grade	72	15	146	—	233	7.8	—
Unrated	—	135	33	2	170	5.7	26
Total	2,093	314	425	151	2,983	100	180
2013							
AAA	96	128	1,091	15	1,330	8.7	1,219
AA to AA+	3,214	179	1,819	30	5,242	34.3	1,946
A to AA-	1,034	111	315	10	1,470	9.6	372
BBB- to A-	1,411	3,524	1,353	—	6,288	41.1	4,679
Non-investment grade	237	211	275	—	723	4.7	428
Unrated	—	189	44	2	235	1.6	—
Total	5,992	4,342	4,897	57	15,288	100	8,644
2012							
AAA	1,383	143	3,791	18	5,335	23.5	3,772
AA to AA+	3,528	525	1,542	124	5,719	25.3	2,026
A to AA-	1,761	150	595	15	2,521	11.1	561
BBB- to A-	972	4,012	3,084	13	8,081	35.7	7,077
Non-investment grade	290	316	25	5	636	2.8	341
Unrated	—	179	2	182	363	1.6	—
Total	7,934	5,325	9,039	357	22,655	100	13,777

Note:

(1) Asset-backed securities.

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Balance sheet analysis continued
Sector and geographical regional analyses
The following tables analyse gross loans and advances to customers and the related debt management measures and ratios by sector and geography (by location of office). Gross loans, REIL and provisions exclude amounts relating to businesses held for disposal, consistent with the balance sheet presentation required by IFRS.

2014	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 charge/(release) €m	Amounts written-off €m
Central and local government	59	—	—	—	—	—	—	—
Financial institutions	1,408	40	9	2.8	23	0.6	(4)	—
Personal	9	—	—	—	—	—	(22)	—
Corporate	2,177	163	100	7.5	61	4.6	(12)	30
Latent impairment	—	—	5	—	—	—	(10)	—
Total	3,653	203	114	5.6	56	3.1	(48)	30
Of which:								
- Netherlands	686	130	41	19.0	32	6.0	(44)	3
- Overseas	2,967	73	73	2.5	100	2.5	(4)	27
Total	3,653	203	114	5.6	56	3.1	(48)	30
2013								
Central and local government	85	—	—	—	—	—	—	—
Financial institutions	1,310	72	16	5.5	22	1.2	38	—
Personal	227	22	22	9.7	100	9.7	8	5
Corporate	2,356	216	143	9.2	66	6.1	(12)	98
Latent impairment	—	—	13	—	—	—	(72)	—
Total	3,978	310	194	7.8	63	4.9	(38)	103
of which:								
- Netherlands	726	178	88	24.5	49	12.1	(35)	70
- Overseas	3,252	132	106	4.1	80	3.3	(3)	33
Total	3,978	310	194	7.8	63	4.9	(38)	103
2012								
Central and local government	891	—	—	—	—	—	—	—
Financial institutions	1,269	61	14	4.8	23	1.1	43	213
Personal	283	41	12	14.5	29	4.2	17	34
Corporate	4,278	404	280	9.4	69	6.5	41	185
Latent impairments	—	—	35	—	—	—	(86)	—
Total	6,721	506	341	7.5	67	5.1	15	432
of which:								
- Netherlands	1,672	253	155	15.1	61	9.3	6	50

- Overseas	5,049	253	186	5.0	74	3.7	9	382
Total	6,721	506	341	7.5	67	5.1	15	432

Available-for-sale debt securities and reserves

The table below analyses available-for-sale (AFS) debt securities by issuer and related AFS reserves net of tax, relating to securities issued by governments and other entities by country.

	2014					2013					2012				
	Govern-ment	ABS	Other	Total	AFS Reserve	Govern-ment	ABS	Other	Total	AFS Reserve	Govern-ment	ABS	Other	Total	Res
	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m	€r
Netherlands	—	154	99	253	(47)	668	2,938	67	3,673	(113)	714	6,039	172	6,925	(6
Spain	52	—	—	52	(2)	52	4,944	—	4,996	(573)	45	5,871	—	5,916	(1
Germany	111	—	54	165	—	400	—	50	450	(2)	1,812	300	54	2,166	(3
United States	—	—	19	19	—	1,711	57	—	1,768	(25)	1,872	59	9	1,940	(4
France	254	—	13	267	(11)	431	137	—	568	(42)	529	635	9	1,173	(6
Italy	135	—	—	135	(41)	514	—	—	514	(60)	501	149	—	650	(1
Belgium	324	—	9	333	(17)	531	—	—	531	(41)	1,006	—	—	1,006	(5
India	533	—	—	533	—	487	—	198	685	(5)	—	—	—	—	—
Austria	208	—	113	321	(2)	340	182	31	553	(30)	367	184	110	661	(3
China	266	—	46	312	(2)	187	—	—	187	—	214	—	27	241	—
Other	64	—	195	259	55	254	386	43	683	7	369	540	25	934	(8
Total	1,947	154	548	2,649	(67)	5,575	8,644	389	14,608	(884)	7,429	13,777	406	21,612	(2

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Market risk

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Market risk

Definition

Market risk is the risk of losses arising from fluctuations in interest rates, credit spreads, foreign currency rates, equity prices, commodity prices and other factors, such as market volatilities, that may lead to a reduction in earnings, economic value or both.

Sources of risk

RBSH Group is exposed to traded market risk through its trading activities and to non-traded market risk as a result of its banking activities. In many respects, it manages its traded and non-traded market risk exposures separately, as described in this section, largely in line with the regulatory definitions of the trading and non-trading books.

Traded market risk

The majority of RBSH Group's traded market risk exposure arises in CIB and RCR.

The primary objective of RBSH Group's trading activities is to provide a range of financing, risk management and investment services to its customers, including major corporations and financial institutions around the world. From a market risk perspective, RBSH Group's trading activities are included within the following markets: currencies; emerging markets; rates; asset-backed products; and traded credit.

RBSH Group undertakes transactions in financial instruments including debt securities, loans, deposits and equities, as well as securities financing and derivative transactions.

Some of these transactions involve trading or clearing financial instruments on an exchange, including interest rate swaps, futures and options. Holders of these instruments provide margin on a daily basis with cash or other security at the exchange.

Other products are not transacted on an exchange. Of these over-the-counter transactions, those with standard terms are cleared through central counterparties, while those that are more complex are settled directly with the counterparty and may give rise to counterparty credit risk, which RBSH Group manages actively.

Non-traded market risk

The majority of RBSH Group's non-traded market risk exposure arises from assets and liabilities that are not classified as held for trading.

The management of non-traded market risk is largely organised in line with the following two key categories: non-traded interest rate risk (NTIRR) and non-traded foreign exchange risk. RBSH Group has no material exposure to non-traded equity risk.

Interest rate risk

NTIRR arises from the provision to customers of a range of banking products that have differing interest rate characteristics. Therefore, when aggregated, these products form portfolios of assets and liabilities with varying degrees of sensitivity to changes in market interest rates. Mismatches in these sensitivities can give rise to volatility in net interest income as interest rates rise and fall.

Foreign exchange risk

Non-traded foreign exchange risk exposures for RBSH Group arise from two main sources:

- Structural foreign exchange risk - arising from the capital deployed in foreign subsidiaries, branches and associates and related currency funding where it differs from the euro; and

- Transactional foreign exchange risk - arising from customer transactions and profits and losses that are in a currency other than the functional currency of the transacting operation.

Equity risk
RBSH Group has no material exposure to non-traded equity risk.

Risk governance
RBS Group's Market Risk function is responsible for identifying, measuring, monitoring and controlling the market risk arising from both trading and non-trading activities.

For general information on risk governance, refer to the Risk governance section on pages 26 to 30.

More specific information on the governance, management and measurement of traded and non-traded market risk is provided in each of the dedicated sections below.

Traded market risk
Controls and assurance
RBS Group's market risk control and assurance framework has three key components: market risk policy; assurance approach policy; and independent assurance.

The Group Market Risk Policy Standard is part of the Group Policy Framework. It sets out the rules that RBS Group's businesses must follow to ensure that market risks are identified, measured and effectively managed.

The assurance approach policy comprises various elements, including the Risk and Control Assurance Framework process. This process ensures that, on an ongoing basis, specifically designed controls are in place for the risks that RBS Group faces to ensure that its exposure does not exceed its appetite. The adequacy and effectiveness of these controls are tested according to their rating, at least annually. The results of this testing are shared regularly at the Market Risk Governance and Control Committee.

Market Risk Assurance forms part of Risk Assurance. This independent second line of defence function provides assurance on the robustness of the market risk framework within RBS Group, via centralised analysis of the control framework, complemented by the application of expert judgement through qualitative reviews. These findings are escalated to senior management and plans to address any shortcomings are recorded and tracked in the operational risk system. Market Risk Assurance activities are also reported directly and independently to the Group Audit Committee.

For information on valuation controls, independent price verification and model validation, refer to page 69.

Risk appetite*
Market risk appetite is the level of market risk that RBSH Group accepts when pursuing its business objectives, taking into account stressed scenarios. RBSH Group has a comprehensive structure and controls in place aimed at ensuring that this appetite is not exceeded. RBSH Group's risk appetite is aligned with that of RBS Group.

RBS Group's qualitative market risk appetite is set out in policy statements. These define the governance, responsibilities, control framework and requirements for the identification, measurement, analysis, management and reporting of market risk arising from trading and non-trading activities. These policies are also cascaded, as appropriate, to the legal entities, franchises and businesses to ensure there is a consistent control framework throughout.

The quantitative market risk appetite is expressed in terms of limits for the trading and non-trading activities. These limits, which establish a set of comprehensive boundaries within which business activities are conducted and monitored based on business plans, are proposed by the Director of Market Risk.

Once RBS Group-level limits are approved by the Executive Risk Forum (ERF), the Director of Market Risk may cascade the limits further down the organisation as required. For each trading business, a document known as a dealing authority compiles details of all applicable limits and trading restrictions.

The limit framework at RBS Group level comprises value-at-risk (VaR), stressed value-at-risk (SVaR) and sensitivity and stress limits (for more details on VaR and SVaR, refer to pages 67 and 68). The limit framework at the lower levels also comprises additional metrics that are 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.

The limits are reviewed to reflect changes in risk appetite, business plans, portfolio composition and the market and economic environments.

Limit breaches at RBS Group level require escalation by the Director of Market Risk, as appropriate, to the ERF. Limit breaches at the lower levels require escalation by the head of the relevant market risk segment to the Director of Market Risk, as appropriate.

Risk assessment
Identification and assessment of traded market risk is achieved through gathering, analysing, monitoring and reporting market risk information by business line or at a consolidated level. Industry expertise, continued system developments and techniques such as stress testing are also used to enhance the effectiveness of the identification of all material market risks.

This is complemented by the New Product Risk Assessment process, which requires market risk teams to assess and quantify market risk associated with all proposed new products.

Risk monitoring
RBSH Group's traded market risk exposures are monitored against limits and analysed daily by market risk reporting and control functions. A daily report that summarises RBSH Group's market risk exposures against the limits is sent to the RBSH Group Head of Market Risk.

The market risk functions also prepare daily risk reports that detail exposures against a more granular set of limits and triggers.

Finally, a market risk update is included in the monthly risk management report sent to RBSH Group Risk and Control Committee (RCC).

Risk control

To ensure approved limits are not breached and that RBS Group remains within its risk appetite, triggers at RBS Group and lower levels have been set such that if exposures exceed a specified level, action plans are developed by the front office, Market Risk and Finance.

Counterparty Exposure Management

Management of the RBS Group’s over-the-counter derivative counterparty credit risk and funding risk is carried out by the Counterparty Exposure Management (CEM) desk in CIB. CEM actively manages risk exposures and concentrations on behalf of both CIB and RCR. The hedging transactions CEM enters into are booked in the trading book and therefore contribute to the RBS Group’s market risk VaR exposure and capital.

Risk measurement

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. For internal risk management purposes, RBS Group’s VaR assumes a time horizon of one trading day and a confidence level of 99%. RBS Group's VaR model is based on a historical simulation, utilising data from the previous 500 days on an equally weighted basis.

At RBSH Group level, a different VaR model is employed. It remains based on a historical simulation model and assumes a time horizon of one trading day and a confidence level of 99%. However, it uses 401 observations of historical market data exponentially weighted with a weighted average history of six months.

VaR limitations*

Historical simulation VaR and RBSH Group’s implementation have a number of known limitations, as summarised below, and RBSH Group’s VaR should be interpreted in light of these.

- Historical simulation VaR may not provide the best estimate of future market movements. It can only provide a forecast of portfolio losses based on events that occurred in the past. The RBSH Group model uses the previous 401 days of data; this period represents a balance between model responsiveness to recent shocks and risk factor data coverage.

- The use of a 99% confidence level VaR statistic does not provide information about losses beyond this level, usually referred to as ‘tail’ risks. These risks are more appropriately assessed using measures such as Stressed VaR and stress testing.

*unaudited

Financial review Capital and risk management

- The use of a one-day time horizon will not fully capture the profit and loss implications of positions that cannot be liquidated or hedged within one day. This may not fully reflect market risk at times of severe illiquidity in the market when a one-day period may be insufficient to liquidate or hedge positions fully. Thus, the regulatory VaR that is used for modelled market risk capital uses a ten-day time horizon.

- RBSH Group computes the VaR of trading positions at the close of business. Positions may change substantially during the course of the trading day and so intra-day price volatility and trading may not be captured by the model.

- Risk factors relevant to a specific portfolio may be omitted, due to a lack of reliable data, or the use of proxy risk factors, for example. RBSH Group has developed the Risks not in VaR (RNIV) framework to address these issues.

- RBSH Group's approach is to supplement VaR with other metrics that addresses the above limitations to ensure appropriate coverage of all material risks.

VaR validation*
A dedicated model-testing team within RBS Group Market Risk works with the risk managers to:

- Test the accuracy of the valuation methods used in the VaR model on appropriately chosen test portfolios and trades.

- Apply in-house models to perform advanced internal back-testing to complement the regulatory back-testing.

- Identify risks not adequately captured in VaR, and ensure that such risks are addressed via the RNIV framework.

- Identify any model weaknesses or scope limitations and their impact.

- Identify and give early warning of any market or portfolio weakness that may become significant.

As well as being an important market risk measurement and control tool, the VaR model is also used to determine a significant component of the market risk capital requirement. Therefore, it is subject to not only ongoing internal review and validation but also regulator-prescribed back-testing.

VaR back-testing*
The main approach employed to assess the ongoing model 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. There are two types of profit and loss (P&L) used in back-testing comparisons: Clean P&L and Hypothetical (Hypo) P&L.

The Clean P&L figure for a particular business day is the firm's actual P&L for that day in respect of the trading activities within the scope of the firm's regulatory VaR model, adjusted by stripping out:

- Fees and commissions;

- Brokerage;

- Additions to, and releases from, reserves that are not directly related to market risk; and

- Any Day 1 P&L exceeding an amount of £500,000 (per transaction).

The Hypo P&L reflects the firm's Clean P&L excluding any intra-day activities.

A portfolio is said to produce a back-testing exception when the Clean 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 taking appropriate remediation or development action. RBSH Group monitors both Clean and Hypo back-testing exceptions.

Regulatory back-testing is performed and reported on a daily basis. Market risk teams also perform back-testing at the lower levels as part of the internal ongoing VaR model validation.

The VaR model is categorised as green, amber or red. A green model is consistent with a good working model and is achieved for models that have four or fewer back-testing exceptions in a 12 month period. For RBSH Group's trading book, a green model status was maintained throughout 2014.

SVaR*

As with VaR, the SVaR technique 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 is run daily for 99% VaR on the current portfolio for each 260-day period from 1 January 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 401-day historical data set. For the purposes of both internal risk management and regulatory SVaR calculation, a time horizon of ten trading days is assumed with a confidence level of 99%.

Risks not in VaR (RNIV)*

The RNIV approach is used for market risks that fall within the scope of VaR and SVaR but that are insufficiently captured by the model methodology, for example due to a lack of suitable historical data. The RNIV framework has been developed to quantify these market risks and to ensure that RBSH Group holds adequate capital.

*unaudited

The need for an RNIV is typically identified in one of the following two circumstances: (i) as part of the New Product Risk Assessment process, when a risk manager assesses that the associated risk is not adequately captured by the VaR model; or (ii) as a result of a recommendation made by Model Risk or the model validation team when reviewing the VaR model.

The RNIVs provide a capital estimate of risks not captured in the VaR model and are regularly reported and discussed with senior management and the regulator. The methodology used in the material RNIV calculations is internally reviewed by Model Risk. Where appropriate, risk managers set sensitivity limits to control specific risk factors giving rise to the RNIV. RNIVs form an integral part of RBSH Group's ongoing model and data improvement efforts to capture all market risks in scope for model approval in VaR and SVaR. Since the introduction of the RNIV framework, progress has been made in transitioning RNIVs into the VaR model.

RBSH Group adopts two approaches for the quantification of RNIVs:

- A standalone VaR approach. Under this approach, two values are calculated: (i) the VaR RNIV; and (ii) the SVaR RNIV.

- A stress-scenario approach. Under this approach, an assessment of ten-day extreme, but plausible, market moves is used in combination with position sensitivities to give a stress-type loss number – the stressed RNIV value.

For each legal entity covered by RBS Group's PRA VaR model waiver, RNIVs are aggregated to obtain the following three measures: (i) Total VaR RNIV; (ii) Total SVaR RNIV; and (iii) Total stressed RNIV. A similar process is followed for the market risk in RBSH Group. In each case, no allowance is made for potential diversification in respect of material RNIVs.

Stress testing*
RBSH Group undertakes daily market risk stress testing to identify vulnerabilities and potential losses in excess of or not captured in VaR. The calculated stresses measure the impact of changes in risk factors on the fair values of RBSH Group's trading and available-for-sale portfolios. RBSH Group conducts scenario-based sensitivity analysis and historical and vulnerability-based stress testing.

Scenario-based sensitivity analysis measures the sensitivity of the current portfolio to defined movements in market risk factors. These risk factor movements and the resulting valuation changes are typically smaller than those considered in other stress tests.

Historical stress testing is a measure that is used for internal management. Using a similar technical framework to VaR, the current portfolio is stressed using historical data since 1 January 2005. The methodology simulates the impact of the worst loss that would be incurred by historical risk factor movements over the period, assuming a holding period specific to the risk factors and the businesses.

At present, a holding period of 60 business days is applied for credit risk factors (including in the case of ABS) and for the AFS portfolios that are held by CIB Treasury and generally a period of 10 business days for other risk factors. RBS Group reviews the holding periods annually.

Historical stress tests form part of the RBSH Group market risk limit framework and stress test exposures are discussed with senior management and relevant information is reported to the RBSH Group Risk and Control Committee (RCC), the RBS Group Board and the RBSH Group Managing Board. Breaches in RBSH Group's market risk stress testing limits are monitored and reported.

Vulnerability-based stress testing begins with the analysis of a portfolio and expresses the key vulnerabilities of the portfolio in terms of plausible, so-called vulnerability scenarios under which the portfolio would suffer material losses. These scenarios can be historical, forward-looking, macroeconomic or hypothetical. Vulnerability-based stress testing is used for internal management information and is not subject to limits. However, relevant scenarios are reported to senior management.

In addition, RBS Group carries out macroeconomic stress tests periodically as part of the firm-wide, cross-risk capital planning process. The scenario narratives are translated into risk factor shocks using historical events and insights by economists, risk managers and the front office. Market risk stress results are combined with those for other risks into the capital plan that is presented to the RBS Group Board. The cross-risk capital planning process is conducted twice a year, in April/May and October/November, with a planning horizon of five years. The scenario narratives cover both regulatory scenarios such as the PRA Anchor and the Federal Reserve Comprehensive Capital Analysis and Review and macroeconomic scenarios identified by the firm such as a euro crisis and a China hard landing.

Calculation of regulatory capital*

The market risks subject to capital requirements under Pillar 1 are primarily interest rate, credit spread and equity risks in the trading book. Interest rate and equity risks are split between general and specific risks. General risks represent market risks due to a move in a market as a whole, such as a main index or yield curve, while specific risks represent market risks arising from events particular to an underlying issuer.

Firms can choose from two broad methodologies to calculate their market risk capital charge: (i) the standard rules, whereby regulator-prescribed rules must be applied, and (ii) the internal model approach, where, subject to regulatory approval, a model such as VaR is used to calculate the capital charge.

The VaR model has been approved by the DNB to calculate regulatory capital for the trading book via a scaling approach of 10 days. RBSH Group’s SVaR model has also been approved by the DNB for use in the capital requirement calculation.

The regulatory VaR and SVaR differ from internal VaR and SVaR as they cover only regulator-approved products, locations and legal entities. VaR and SVaR capture general and specific risks but not risks arising from the impact of defaults and rating changes associated with traded credit products and their derivatives.

The Incremental Risk Charge (IRC) model captures risks arising from defaults and rating changes for the more liquid traded credit instruments and their derivatives held in the trading book. It is calculated over a one year horizon to a 99.9% confidence level, and therefore represents a 1-in-1,000 loss over the following year.

*unaudited

Market risk analyses

Trading VaR

The table below analyses the internal VaR for RBSH Group's trading portfolios segregated by type of market risk exposure.

	2014				2013				2012			
	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimum
Trading VaR summary	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m
Interest rate	2.1	1.8	4.8	1.1	1.7	1.1	3.4	0.7	3.0	2.0	7.4	1.8
Credit spread	2.1	1.8	4.0	0.1	0.2	0.1	0.9	—	1.4	0.8	3.9	0.8
Currency	1.4	1.5	3.0	0.6	1.1	0.8	2.6	0.4	1.7	1.3	11.3	0.6
Equity	0.5	0.2	1.3	0.1	0.3	0.1	1.1	0.1	2.1	0.7	9.7	0.5
Commodity	0.4	0.7	1.0	0.1	0.2	—	1.5	—	0.9	0.6	3.1	0.4
Diversification (1)		(3.3)				(0.5)				(2.8)		
Total	3.2	2.7	5.7	2.0	2.0	1.6	3.4	0.9	4.4	2.6	11.3	2.1

Note:

(1) RBSH Group benefits from diversification, which reflects the risk reduction achieved by allocating investments across various financial instrument types, industry counterparties, currencies and regions. The extent of diversification benefit depends on the correlation between the assets and risk factors in the portfolio at a particular time.

Key points

- The main driver of the higher VaR utilisation in 2014 was an increase in volatility related to an onshore renminbi currency position that RBSH Group holds as a result of the unwinding of the equity business.

- In addition, improvements to certain information technology architectures resulted in a degree of VaR volatility during H1 2014.

Valuation and independent price verification

Within RBS Group, traders are responsible for marking-to-market their trading book positions daily, ensuring that assets and liabilities in the trading book are measured at their fair value. Any profits or losses on the revaluation of positions are recognised daily.

Product controllers are responsible for ensuring that independent price verification processes are in place covering all trading book positions held by their business. Independent price verification and trader supervision are the key controls over front office marking of positions.

The validation of pricing models is discussed below.

Model validation

RBS Group's independent model validation framework governing both pricing models and risk models (including VaR) is described below.

RBS Group uses a variety of models to manage and measure market risk, as described below. These models comprise pricing models (used for valuation of positions) and risk models (for risk measurement and capital calculation purposes). They are developed in both RBS Group-level and lower-level functions and are subject to independent review and sign-off.

A dedicated independent model review and challenge function - Model Risk - performs reviews of relevant models in two instances: (i) for new models or amendments to existing models and (ii) as part of its ongoing programme to assess the performance of these models.

A new model is typically introduced when an existing model is no longer fit for purpose or a new product requires a new methodology or model to quantify the risk appropriately. Amendments are usually made when a weakness is identified during use of a model or following analysis either by the model developers or by Model Risk.

Pricing models*

Pricing models are developed by a dedicated front office quantitative team, in conjunction with the trading desk. They are used for the valuation of positions for which prices are not directly observable and for the risk management of the portfolio.

Any pricing models that are used as the basis for valuing books and records are subject to approval and oversight by asset-level modelled product review committees.

These committees comprise representatives of the major stakeholders in the valuation process - trading, finance, market risk, model development and model review functions.

The review process comprises the following steps:

- The committees prioritise models for review by Model Risk, considering the materiality of the risk booked against the model and an assessment of the degree of model risk, that is the valuation uncertainty arising from the choice of modelling assumptions.

- Model Risk quantifies the model risk by comparing front office model outputs with those of alternative models independently developed by Model Risk.

- The sensitivities derived from the pricing models are validated.

- The conclusions of the review are used by Market Risk to inform risk limits and by Finance to inform model reserves.

*unaudited

Risk models*
All new risk models are subject to review and sign-off by Model Risk.
All model changes are approved through model governance at the franchise level. Changes to existing models that have an impact on VaR exceeding 5% at legal entity level or 15% at a major business level are also subject to Model Risk review and sign-off as are all model changes that require regulator approval before implementation.

Model Risk's independent review comprises some or all of the following steps, as appropriate:

- Testing and challenging the logical and conceptual soundness of the methodology;
- Testing the assumptions underlying the model, where feasible, against actual behaviour. In its validation report, Model Risk will opine on the reasonableness and stability of the assumptions and specify which assumptions, if any, should be routinely monitored in production;
- Testing whether all key market risks have been sufficiently captured;
- Re-applying the proposed approach to verify that the same outcome is achieved;
- Comparing outputs with results from alternative methods;
- Testing parameter selection and calibration;
- Ensuring model outputs are sufficiently conservative in areas where there is significant model uncertainty;
- Confirming the applicability of tests for accuracy and stability; recalculating and ensuring that results are robust; and
- Ensuring appropriate sensitivity analysis has been performed and documented.

Based on the review and findings from Model Risk, an internal model governance committee with appropriate delegated authority considers whether a model can be approved for use and whether any conditions need to be imposed, including those relating to the remediation of material issues raised through the review process. Once approved through internal governance, the new or amended model is implemented. Models used by RBSH Group for regulatory reporting may additionally require DNB approval before implementation.

Model Risk also reassesses the appropriateness of approved risk models on a periodic basis according to the approved Periodic Review Policy. Each periodic review consists of a quick scan assessment and a subsequent decision by an internal model governance committee with appropriate delegated authority to re-ratify a model based on the quick scan assessment or to perform additional work prior to making a decision whether or not to re-ratify a model. In the quick scan assessment Model Risk assesses changes since the last approval along the following dimensions: change in size/composition of the portfolio, market changes, model performance, model changes, status of any outstanding issues, scheduled activities including work carried over from previous reviews.

This independent oversight also provides additional assurance that RBS Group holds appropriate capital for the market risk to which it is exposed.

The model testing team in Market Risk also performs regular VaR model testing, which is discussed in more detail under Risk measurement - value-at-risk on page 66.

Non-traded market risk*
RBSH Group manages non-traded market risk separately for non-traded interest rate risk and non-traded foreign exchange risk.

Controls and assurance
The ERF approves the non-traded market risk framework. The non-traded market risk policy statement sets out the governance and risk management framework through effective identification, measurement, reporting, mitigation, monitoring and control.

The models used for managing non-traded market risk are subject to the validation process described above.

Risk appetite*
RBSH Group's appetite for non-traded market risk is approved by the Supervisory Board limits as recommended by the Director of Market Risk and the ALCo. Further information on the process and the limit framework can be found on pages 41 to 44.

Interest rate risk
RBSH Group policy is to manage interest rate sensitivity in banking book portfolios within defined risk limits. Interest rate risk is transferred from the banking divisions to RBSH Group Treasury. Aggregate positions are then hedged externally using cash and derivative instruments, primarily interest rate swaps, to manage exposures within RBSH Group Asset and Liability Management Committee approved limits. RBSH Group is required to manage non-traded interest rate risk (NTIRR) through transactions with RBS plc to the greatest extent possible.

Residual risk positions are routinely reported to ALCo, the Managing and Supervisory Boards and the RCC.

Key measures used to evaluate NTIRR are subjected to approval granted by the ALCo. Limits on NTIRR are set according to the Non-Trading Interest Rate and Foreign Currency Risk Policy Statement and are subject to RBSH Group ALCo approval.

NTIRR is measured using a version of the same Value at Risk (VaR) methodology that is used by RBS Group. VaR metrics are based on interest rate repricing gap reports as at the reporting date. These incorporate customer products and associated funding and hedging transactions as well as non-financial assets and liabilities such as property, equipment, capital and reserves. Behavioural assumptions are applied as appropriate.

NTIRR one-day VaR at 99% confidence level for RBSH Group's retail and commercial banking activities was as follows. The figures exclude the banking books of Short Term Markets and Finance (STMF) which are managed by the traded market risk function.

*unaudited

	Average	Period end	Maximum	Minimum
	€m	€m	€m	€m
2014	8.6	6.3	9.9	5.4
2013	5.4	10.1	10.6	2.0
2012	6.0	5.2	9.6	4.4

Key point
- RBSH Group's exposure to interest rate risk fell from end-2013 to end-2014 as a result of further business transfers to RBS plc as well as shorter maturity assumptions for some capital securities.

Structural foreign currency exposures
RBSH Group does not maintain material non-trading open currency positions, other than the structural foreign currency translation exposures arising from its investments in foreign subsidiaries and associated undertakings and their related currency funding.

The table below sets out RBSH Group's structural foreign currency exposures.

	Net investments in foreign operations (1)	Net investment hedges	Structural foreign currency exposures
2014	€m	€m	€m
US dollar	1,047	(687)	360
Pound sterling	277	(215)	62
Other non-euro	2,025	(1,770)	255
	3,349	(2,672)	677
2013			
US dollar	1,176	(533)	643
Pound sterling	(15)	15	—
Other non-euro	1,768	(1,660)	108
	2,929	(2,178)	751
2012			
US dollar	1,259	(960)	299
Pound sterling	(397)	75	(322)
Other non-euro	2,558	(2,034)	524
	3,420	(2,919)	501

Note:
(1) Includes minority participations.

Key points
- RBSH Group's structural foreign currency exposure at 31 December 2014 was €0.7 billion, a net decrease of €0.1 billion on 2013. Net investments in foreign operations increased by €0.4 billion, while net investment hedges

increased by €0.5 billion.

- Changes in foreign currency exchange rates will affect equity in proportion to structural foreign currency exposure. A 10% strengthening in foreign currencies against the euro would result in a gain in equity of €75 million (2013 - €75 million; 2012 - €45 million), while a 10% weakening would result in a loss of €62 million (2013 - €75 million; 2012 - €55 million).

*unaudited

Country risk

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Country risk

Definition

Country risk is the risk of losses occurring as a result of either a country event or unfavourable country operating conditions. As country events may simultaneously affect all or many individual exposures to a country, country event risk is a concentration risk. For other types of concentration risks such as product, sector or single-name concentration, refer to the Credit risk section.

Sources of risk

Country risk has the potential to affect all parts of RBSH Group's portfolio across wholesale and retail activities that are directly or indirectly linked to the country in question. It arises from possible economic or political events in each country to which RBSH Group has exposure, and from unfavourable conditions affecting daily operations in a country.

Country events may include a sovereign default, a political conflict, a banking crisis or a deep and prolonged recession leading to possible counterparty defaults. Transfer or convertibility restrictions imposed by a country's government to stem the loss of foreign currency reserves may temporarily prevent counterparties from meeting their foreign currency payment obligations. Major currency depreciation may also affect a customer's income or debt burden, leading to default.

Unfavourable operating conditions may include the risk that a weak or creditor-unfriendly legal system within a country makes it difficult for RBSH Group to recover its claims in the event of customer default. An unreliable or unstable political system may lead to sudden compliance or reputational issues, or even expropriation without proper compensation.

Overview*

The conflict between Ukraine and Russia and the consequent escalating tensions between Russia and the West triggered an internal review of credit grades and limits.

The eurozone region emerged from recession, with some of the periphery countries recovering but growth in other countries, including Germany mostly sluggish. The EU's Single Supervisory Mechanism (SSM) commenced in November 2014 when the European Central Bank (ECB) assumed supervisory responsibility for the 130 largest banks of the eurozone, after concluding a detailed Asset Quality Review of their books, adjusting balance sheets and stress testing their capital positions. This SSM is the first pillar of the EU Banking Union that should reduce the risk of a repeat of the financial crisis over the longer term and that helps to support the quality of the bank's exposure, particularly in Europe. The other pillar will be the Single Resolution Mechanism, scheduled for 2016.

Important shifts in exposure occurred in 2014 as a result of the sale of a significant portion of RBSH Group's liquidity portfolio bonds following internal asset quality reviews and stress tests. The sale consisted of Spanish covered bonds, contributing to a reduction in Spanish net balance sheet exposure to €0.1 billion (2013 - €5.0 billion; 2012 - €6.0 billion).

Outlook for 2015*

In 2015, recovery in the advanced economies will likely remain uneven, with widening differentials between the US and Europe in growth, price levels and policies. The policy divergence will be amplified by the January 2015 ECB announcement of a €1,000 billion quantitative easing programme, aimed at reversing deflation and stimulating credit growth, while the US Federal Reserve is expected to start tightening interest rates in the second half of 2015.

The Chinese economy continues its structural slowdown; broad reforms aim at ensuring more sustainable long-term growth, but accumulated financial vulnerabilities bear downside risks. Growth in emerging markets is expected to be restrained by reduced capital inflows, depressed global commodity prices, and geopolitical conflicts, at times resulting in market volatility in the most vulnerable economies.

Governance*

All country exposures in RBSH Group are covered by RBS Group's country risk framework and a further set of specific RBSH Group country limits.

The RBS Group's country risk framework is set by the RBS Group Executive Risk Forum (ERF). This body delegates authority to set sovereign ratings, sovereign loss-given-default rates, and country Watchlist colours to the Group Chief Credit Officer (CCO), who may further delegate this authority to Strategic Risk. The ERF delegates authority to decide on country risk matters such as risk appetite, risk management strategy and framework, and risk exposure and policy to the Credit Risk Committee (CRC), which may further delegate to Country Risk Management (CoRM). This includes the setting of country limits, where appropriate including allocations for specific product groups. The CCO and CRC can escalate issues to the ERF when necessary.

For further information on governance, refer to the Risk governance section on pages 26 to 30.

Risk appetite*

RBS Group's country risk appetite framework has "top-down" and "bottom-up" components.

The top-down component is guided by RBS Group's global risk appetite; each country's internal sovereign rating; its strategic importance to RBS Group; the composition of RBS Group's portfolio; the funding profile; and an assessment of the potential for losses arising from possible key country risk events. This component provides a clear structure for the consideration of downside scenarios, the identification of countries that pose material concentration risks to RBS Group, and possible management actions.

Bottom-up analysis includes the risk/return relationship as well as reputational and regulatory risk.

*unaudited

RBS Group country limits are set for almost all countries. The UK is an exception, given its home country status. The US is another exception because of the specific local risk management structure, the size of the local portfolio and corresponding role in RBS Group-wide risk management, together with the country's strong ratings and corresponding role in RBS Group-wide risk management, together with the country's strong ratings.

Specific RBSH Group country limits (capped by the overall RBS Group limits) are set by the RBSH Group Risk and Control Committee, which reports to the RBSH Group Board. The RBSH Group country limits leave only limited headroom for countries to which most of the RBSH Group exposure has migrated and that are on run-off, while allowing sufficient room for a small number of ‘active’ countries where exposure is still awaiting migration. Exposures to the Netherlands (the RBSH Group home country), the UK and the US, are exempt from RBSH Group country limits.

Risk mitigation*
Part of RBSH Group’s exposure is mitigated by guarantors or insurers (including export credit agencies), credit default swap (CDS) protection providers, or collateral in third countries, which will not be directly affected by a country event in the obligor’s country. Further details on credit mitigation instruments are provided in the Credit risk section.

CDS contracts are used to hedge either entire portfolios or specific individual exposures. These transactions are subject to regular margining, which usually takes the form of cash collateral. For European peripheral sovereigns, credit protection is purchased from a number of major European banks, mostly outside the country of the reference entity. In a few cases where protection was bought from banks in the country of the reference entity, giving rise to wrong-way risk, this risk is mitigated through specific collateralisation and monitored weekly.

Risk monitoring*
The CoRM team monitors and reports on RBS Group exposures to all countries, and follows up in the event of limit excesses. CoRM has delegated authority up to specified levels to decide on RBS Group country limit increases; any such decision must be reported to the CRC. Persistent excesses are escalated to the CRC. Regular reports that summarise RBSH Group’s remaining country risks are sent to senior RBSH Group management and RBSH Group limit excesses are followed up.

A country risk Watchlist process identifies emerging issues, facilitating the development of mitigation strategies.

Countries Watchlisted Amber are monitored closely. Appetite for countries Watchlisted Red is limited to short-term business in areas such as trade finance and derivatives, unless the country is deemed a strategic priority country.

Detailed portfolio reviews are conducted to ensure that the composition of country portfolios remains aligned with RBS Group’s country risk appetite in light of economic and political developments. Changes in sovereign ratings or country Watchlist status trigger a review of appetite and, where appropriate, are referred to the CRC for discussion.

Measurement*
In this section, country exposure includes wholesale and retail net on-balance sheet exposure (drawn amounts under lending facilities, net of provisions, mark-to-market derivatives positions and issuer-risk debt securities positions in the banking book and trading book) together with off-balance sheet exposure (contingent obligations and undrawn commitments).

RBS Group also estimates its funding mismatches at risk of redenomination in vulnerable eurozone countries. These mismatches are defined as the exposures (net of provisions) that would be expected to convert to a new national

currency minus the liabilities that would be expected to re-denominate at the same time. The exposures exclude balances at low risk of redenomination, as identified through consideration of the relevant documentation, particularly the currency of exposure, governing law, court of jurisdiction, precise definition of the contract currency (for euro facilities), and location of payment.
Similar estimates are made for RBSH Group. It is noted that RBS Group has publicly stated it will support RBSH Group in case of need.

Basis of preparation
The tables in this section show RBSH Group's exposure at 31 December 2014, 2013 and 2012. Exposures are reported by country of operation of the obligor, except exposures to governments and individuals, which are shown by country of residence.

The country of operation is the country where the main operating assets of a legal entity are held, or where its main cash flows are generated, taking account of the entity's dependency on subsidiaries' activities.

Countries shown are those which had ratings of A+ or below from Standard and Poor's, Moody's or Fitch at 31 December 2014, where RBSH Group's balance sheet exposure (as defined in this section) to counterparties operating (or individuals residing) in them exceeded €0.5 billion. Also included are selected eurozone countries.

The exposures are stated before taking into account risk mitigants such as guarantees, insurance or collateral (with the exception of reverse repos) which may have been put in place to reduce or eliminate exposure to country risk events. The tables show net CDS positions separately, as RBSH Group may be either a net buyer or a net seller of protection.

*unaudited

Summary of country exposures

	Net balance sheet exposure						Analysis of net balance sheet exposures						CDS notional less fair value
2014	Sovereign €m	Banks €m	Other FI €m	Corporate €m	Personal €m	Total €m	Net lending €m	Debt securities €m	Net Derivatives €m	SFT €m	Off-balance sheet €m	Total exposure €m	€m
Eurozone													
Italy	135	707	162	1	—	1,005	138	161	706	—	—	1,005	(196)
Spain	53	1	—	4	—	58	5	53	—	—	3	61	(4)
Ireland	—	—	—	54	—	54	54	—	—	—	12	66	—
Portugal	—	33	9	4	—	46	—	—	46	—	—	46	—
Cyprus	—	—	—	42	—	42	42	—	—	—	—	42	—
Eurozone periphery	188	741	171	105	—	1,205	239	214	752	—	15	1,220	(200)
Belgium	324	148	7	9	—	488	17	333	138	—	4	492	(1)
France	254	4	—	13	—	271	1	267	3	—	148	419	(28)
Germany	141	6	27	53	—	227	50	165	12	—	105	332	(14)
Luxembourg	—	3	—	—	—	3	3	—	—	—	—	3	(1)
Other	217	—	113	—	—	330	—	330	—	—	—	330	(2)
Total eurozone	1,124	902	318	180	—	2,524	310	1,309	905	—	272	2,796	(246)
India	784	2	183	646	—	1,615	912	676	27	—	460	2,075	—
China	428	293	294	543	—	1,558	1,169	312	76	1	292	1,850	—
2013													
Eurozone													
Italy	514	709	168	—	—	1,391	166	514	711	—	5	1,396	(192)
Spain	53	3,363	1,580	10	—	5,006	10	4,996	—	—	61	5,067	(5)
Ireland	169	56	—	—	—	225	—	225	—	—	—	225	—
Portugal	—	89	32	5	—	126	—	85	41	—	—	126	—
Cyprus	—	—	—	42	—	42	42	—	—	—	—	42	—
Greece	—	—	—	2	—	2	2	—	—	—	14	16	—
Eurozone periphery	736	4,217	1,780	59	—	6,792	220	5,820	752	—	80	6,872	(197)
Belgium	531	142	146	—	—	819	146	531	142	—	14	833	(1)
France	431	1	137	—	—	569	1	568	—	—	269	838	(26)
Germany	400	50	—	77	—	527	67	450	10	—	204	731	(14)

Luxembourg	—	53	—	1	—	54	—	1	53	—	—	54	(4)
Other	340	58	124	31	—	553	—	553	—	—	25	578	(2)
Total eurozone	2,438	4,521	2,187	168	—	9,314	434	7,923	957	—	592	9,906	(244)
India	728	249	86	653	—	1,716	797	842	77	—	417	2,133	—
China	425	1,087	239	544	—	2,295	2,000	210	84	1	800	3,095	—

Financial review Capital and risk management

Summary of country exposures

	Net balance sheet exposure						Analysis of net balance sheet exposures						CDS
2012	Sovereign €m	Banks €m	Other FI €m	Corporate €m	Personal €m	Total €m	Net lending €m	Debt securities €m	Net Derivatives €m	SFT €m	Off-balance sheet €m	Total exposure €m	notional less fair value €m
Eurozone													
Italy	500	871	86	136	—	1,593	154	715	724	—	72	1,665	(180)
Spain	45	3,874	1,998	52	—	5,969	53	5,916	—	—	99	6,068	(5)
Ireland	156	218	—	93	—	467	25	433	9	—	47	514	—
Portugal	88	143	44	29	—	304	—	169	135	—	37	341	—
Cyprus	—	—	—	52	—	52	52	—	—	—	—	52	—
Greece	—	1	4	—	—	5	—	—	5	—	15	20	—
Eurozone periphery	789	5,107	2,132	362	—	8,390	284	7,233	873	—	270	8,660	(185)
Belgium	1,006	180	270	4	—	1,460	274	1,006	180	—	88	1,548	(1)
France	529	184	638	116	—	1,467	119	1,173	175	—	551	2,018	(27)
Germany	1,813	432	10	221	—	2,476	156	2,166	148	6	521	2,997	(13)
Luxembourg	—	—	23	11	—	34	16	—	1	17	134	168	(2)
Other	393	59	125	110	—	687	—	687	—	—	43	730	(2)
Total eurozone	4,530	5,962	3,198	824	—	14,514	849	12,265	1,377	23	1,607	16,121	(230)
India	1,006	253	83	1,487	87	2,916	1,716	1,137	63	—	676	3,592	—
China	454	602	72	782	—	1,910	1,551	314	45	—	422	2,332	(11)

Notes:

(1) Net lending - Comprises loans and advances, including cash balances and risk elements in lending - net of provisions.

(2) Debt securities - Comprise securities classified as available-for-sale (AFS), loans and receivables (LAR), held-for-trading (HFT) and designated as at fair value through profit or loss (DFV). All debt securities other than LAR securities are carried at fair value. LAR debt securities are carried at amortised cost less impairment. HFT debt securities are presented as long positions (including DFV securities) net of short positions per country. Impairment losses and exchange differences relating to AFS debt securities, together with interest, are recognised in the income statement. Other changes in the fair value of AFS securities are reported in AFS reserves.

(3) Derivatives (net) - Comprise the mark-to-market (mtm) value of such contracts after the effect of legally enforceable netting agreements in line with the corresponding regulatory capital models, but before the effect of collateral.

(4) Securities financing transactions (SFT) (net) - Comprise the mtm value of the cash and securities that are due to RBS Group at a future date under repurchase agreements, reverse repurchase agreements, stock borrowing, stock lending and equity financing transactions, after the effect of collateral intrinsic to the transaction and legally

enforceable netting agreements. Counterparty netting is applied as per the corresponding regulatory capital approach. Additional collateral called to offset mtm positions (variation margin) is not included.

(5) Net balance sheet exposure - Comprises net lending, debt securities, derivatives (net) and SFT (net) exposures, as defined above.

(6) Off-balance sheet - Comprises net letters of credit, guarantees, other contingent obligations and legally committed undrawn facilities.

(7) Total exposure – Comprises net balance sheet exposure and off-balance sheet exposure, as defined above.

(8) Credit default swaps (CDSs) - Under a CDS contract, the credit risk on the reference entity is transferred from the buyer to the seller. 'Fair value' (or 'mtm value') represents the balance sheet carrying value of the resulting exposure. The mtm value of CDSs is included in derivatives against the counterparty of the trade, as opposed to the reference entity. The notional is the par value of the credit protection bought or sold and is included against the reference entity of the CDS contract. The column 'CDS notional less fair value' represents the net effect on exposure should the CDS contracts be triggered by a credit event, assuming a zero recovery rate on the reference exposure. This net effect would be the increase in exposure arising from sold positions netted against the decrease arising from bought positions. For a sold position, the change in exposure equals the notional less the fair value amount; this represents the amount RBSH Group would owe to its CDS counterparties if the reference entity defaulted. Positive recovery rates would tend to reduce the gross components (increases and decreases) of those numbers. Exposures relating to credit derivative product companies (CDPCs) and related hedges as well as Nth-to-default basket swaps have been excluded, as they cannot be meaningfully attributed to a particular reference entity or country.

(9) Sovereign - Comprises central, regional and local government, and central banks.

(10) Eurozone periphery - Italy, Spain, Ireland, Portugal, Greece and Cyprus.

(11) Other eurozone - Austria, Estonia, Finland, Latvia, Malta, Slovakia and Slovenia. The Netherlands, while being a eurozone country, has been excluded in these country risk tables as RBSH Group is based in the Netherlands.

Key points*

- During 2014, the US dollar and sterling appreciated against the euro by 13.3% and 7.0% respectively, impacting exposures.

- Balance sheet and off-balance sheet exposures to nearly all countries were further wound down during 2014, after the major exposure migrations to RBS plc in 2012-2013.

- Total eurozone (excluding the Netherlands) – net balance sheet exposure declined by €6.8 billion or 73% to €2.5 billion, largely caused by the sale of AFS debt securities exposure, mostly to Spain, from the bank's liquidity portfolio.

- Eurozone periphery – net balance sheet exposure decreased to €1.2 billion, a reduction of €5.6 billion or 82%, largely caused by the sale of Spanish AFS securities.

  - Italy - AFS government bonds exposure decreased by €0.4 billion. The remaining exposure of €1.0 billion mainly comprised €0.7 billion of (largely collateralised) derivatives exposure to banks and €0.2 billion of AFS government bonds. The latter was covered by bought CDS protection.