Asset Protection Agency- Interim Report to 31 December 2011

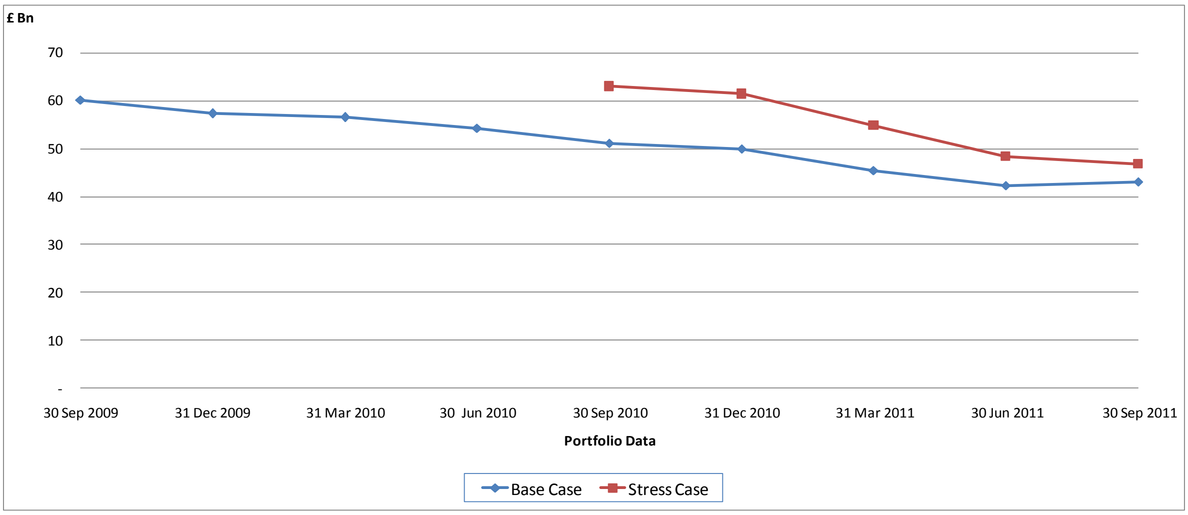
Welcome to the Asset Protection Agency's (APA) interim report, which covers the nine month period to 31 December 2011. During this period the risk in the Asset Protection Scheme (APS) has continued to decline notwithstanding the challenges in the Eurozone. The benefit to RBS' regulatory capital ratios, which the APS provides, has remained significant. Moreover, the APA has continued to function effectively and to realise efficiency gains where possible in recognition of the reduced risk in the APS to the taxpayer.

Operation of the APS

Risk

During the reporting period the financial risk of HM Treasury (HMT) paying out under the Scheme has reduced significantly. The most likely outcome is an overall profit of at least £5bn for HMT from the Scheme. To date HMT have received cash payments of £2.5bn from Lloyds Banking Group and £2.225bn from RBS which underpins this expectation. The Covered Amount has reduced from £286bn at 31 December 2008 to £132bn at 31 December 2011 and the First Loss Utilisation was £32bn at 31 December 2011. As shown in Figure 1, at 30 September 2011 the APA estimated expected loss of £43bn in the base case, down from £45bn as reported in our 2010/11 Annual Report and Accounts. The risk around that expectation has reduced as the portfolio has continued to run down. We therefore have a high degree of confidence that the £60bn First Loss Amount will not be breached, much less the £75bn level at which HMT would be expected to make a permanent payout.

Figure 1: Evolution of APA loss forecasts



Note: APA began stress-testing linked to the FSA scenario in September 2010.
Source: APA analysis

In order to gain further comfort as to the level of risk in the portfolio, the APA has conducted a range of stress tests. The core scenario is the 'anchor' stress test scenario defined by the FSA[1]. This serves

[1] See page 33 and onwards in the FSA's Prudential Risk Outlook 2011, March 2011, http://www.fsa.gov.uk/pubs/other/pro.pdf.

as a well-defined scenario for external communication and a common basis for comparison with RBS. Our analysis shows an expected loss of £47bn in the portfolio under this scenario. The relatively small difference between the base and stress forecasts results from several factors:

- a substantial amount of the loss has crystallised;
- the stress scenario was specified in early 2011 and so does not reflect more recent negative macroeconomic developments;
- the stress scenario develops fairly slowly, so there is considerable runoff of exposure before the stress impacts; and
- although the stress scenario involves a recession in 2013 it is by no means a worst case scenario.

To supplement this analysis and better understand the downside risk in the Scheme, the APA has also performed reverse stress tests, investigating scenarios that would be expected to lead to given levels of loss, specifically £60bn and £75bn. These scenarios have been kept relatively simple, but they are considered to be internally consistent and plausible, if highly unlikely. They are scenarios of deep global depression, with sharp declines in GDP and property valuations accompanied by large increases in unemployment, followed by prolonged stagnation. Our analysis suggests that it would take a 23% drop in global GDP under such a scenario to breach the First Loss Amount and a 41% drop to lead to a permanent payout.

These scenarios also serve as useful benchmarks against which to estimate the potential impact of other, more topical scenarios, in particular a worsening of the situation in the Eurozone. The absence of a good precedent for some of the most severe possible outcomes means that published forecasts of the likelihood and potential macroeconomic impacts are extremely varied. In addition, there are legal and political risks under this scenario that are virtually impossible to predict robustly. With these caveats, we can say that even the most severe published scenarios we have found do not reach the levels of our £75bn reverse stress test.

In addition to the expected loss level, two other factors are relevant in assessing the impact of these scenarios on the APS:

- the timing of RBS' exit; and
- the broader condition of RBS under a stress scenario.

RBS has indicated publicly that it wishes to exit the Scheme in 2012[2], though the FSA must approve RBS' exit from the APS. But only if RBS stays in the Scheme will there be a payout. Thus, not only would a very severe stress scenario have to materialise for a payout to take place, it would also have to become transparent before a decision is made on RBS' exit from the Scheme.

[2] There are two routes that RBS can take to exit the Scheme prior to 31 December 2099. RBS may request termination of its participation by giving notice to HMT. A condition for exit under this route is that the FSA confirms to HMT that it has no objections. The alternative exit-route is for HM Treasury and RBS to bilaterally agree to terminate the Scheme.

Overall, this analysis shows that as the risk of payout by HMT has reduced, so the tail risk insurance that the APS provides RBS is diminishing , though it does still benefit RBS' regulatory capital ratios. In the third quarter of 2011 RBS reported that the APS provided a Core Tier 1 benefit of 1.3%. This benefit is expected to trend towards zero during 2013 due to Basel 3 proposals as the portfolio runs off and the fourth Capital Requirements Directive is implemented. In conclusion, the APS has been a successful intervention stabilising RBS during the initial period of the crisis by offering protection against a continued economic downturn and a worse-than-expected back book. The APS bought time for RBS to de-risk the portfolio and has now reached the point where it is no longer itself vulnerable to any realistic stress scenario.

Investment Management

The APA seeks to reduce risk and maximise value in the APS portfolio by working closely with RBS senior management and asset managers on debt restructurings and sales of the largest APS assets. Our investment management team has materially influenced RBS' analysis, strategy and management of many of these assets. Although APS risk for HMT has diminished we have sought to add value with independent and rigorous asset management expertise. By the end of the 2010/11 financial year the APA had reviewed all larger (>£50m) Covered Assets. During the period under review we stopped reviewing certain low risk assets and instead focused on larger, high risk assets, which form what we now refer to as the "Focus List". The Investment Management Team prioritises these assets for frequency and intensity of monitoring with live restructurings or loan sales being monitored usually on a weekly basis. These initiatives have resulted in more streamlined and better focused reporting by RBS and monitoring by the APA.

As at 31 December 2011 the Focus List comprised 269 borrower groups representing £49.4bn of Covered Amount or 38% of total APS Covered Amount (see Figure 2).

Figure 2: Focus List as a Proportion of Total APS Portfolio

Covered Amount	Commercial Real Estate	%	Corporate/ Leveraged Finance	%	Structured Finance	%	Other	%	Total	%
Focus List	£18.5bn	59%	£11.8bn	24%	£19.2bn	79%	£0.0bn	0%	£49.4bn	38%
Total APS	£31.4bn	100%	£49.5bn	100%	£24.4bn	100%	£26.5bn	100%	£131.8bn	100%
Number of Borrower Groups	**CRE Total**	**%**	**CLF Total**	**%**	**SF Total**	**%**			**Total**	**%**
Focus List	120	2%	68	0%	81	11%	-	0%	269	0%
Total APS	5,650	100%	202,284	100%	739	100%	2,450,483	100%	2,659,156	100%

In addition, the APA has continued its reviews of RBS businesses. During the period reviews were continuing in several areas including the Non-Core Division (NCD), Global Restructuring Group (GRG), structured finance, commercial real estate, unsecured consumer loans and residential mortgages. The purpose of these reviews has been to ensure that the Covered Assets receive the best possible asset management, including outsourced asset management if appropriate. In some cases these reviews resulted in recommendations being made for changes in strategy, operations, reporting, controls or risk management and the APA is working with RBS to implement these changes. In particular, the APA successfully influenced RBS' strategy for commutation of certain large monoline exposures, collection and management of data for Non-Core commercial real estate, better co-ordination of management of Non-Core commercial real estate managed in GRG, improved credit analysis and risk management in GRG and application of capital pricing models in NCD and GRG. The APA is pleased with the progress to date and continues to seek improvements.

With RBS we have implemented the “simplification” of the APS, which provides for the recognition of Losses and Recoveries to be aligned more closely with RBS’ normal accounting procedures. The Scheme rule changes required to permit this were referred to in our 2010/11 Annual Report and Accounts. Implementation of “simplification” has improved operational efficiency and enabled RBS to achieve cost savings.

Operation of the APA

Now that the APS has been operational for more than two years, the APA has matured into an efficient organisation.

A significant change in the period was the departure in October of Stephan Wilcke as Chief Executive Officer. Stephan was instrumental in the establishment of the APA and the APA benefited considerably from his expertise. We are grateful to him for his contribution. Stephan was succeeded by Bill Dickinson, previously the APA’s Chief Financial and Operating Officer and a former partner of KPMG.

In the period from 1 April 2011 to 31 December 2011, the APA’s staffing levels have decreased by 18 per cent. In this period, the APA has not sought to replace departing members of staff – an approach which is commensurate with the decreasing levels of risk described above. This, together with our sparing use of consultants and third party advisers in comparison to earlier periods, has resulted in the APA’s operating costs (which are fully rechargeable to RBS), being less than two thirds of the costs of the equivalent period in 2010.

The APA is on track to achieve all business plan targets for the year to 31 March 2012.

Challenges ahead

We intend to continue to work with RBS to operate the Scheme efficiently and effectively. Our current focus is on “abridged reporting”, which is expected to enable RBS to achieve additional cost savings in 2012 by further aligning RBS’ APS reporting to its business-as-usual processes.

A key role for the APA in 2012 will be to support HMT and the FSA in their deliberations over RBS’ potential exit from the Scheme in the course of the year.