

ROYAL BANK OF SCOTLAND GROUP PLC
 Form 20-F
 March 29, 2005

FORM 20-F

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

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

For the fiscal year ended 31 December 2004

OR TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
 OF THE SECURITIES EXCHANGE ACT OF 1934
 For the transition period from _____ to _____

Commission file number 1-10306

The Royal Bank of Scotland Group plc
Scotland
42 St Andrew Square, Edinburgh EH2 2YE United Kingdom

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

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
American Depositary Shares Series D, E, F, G, H, I, J, K, L and M each representing one Non-Cumulative Dollar Preference Share, Series D, E, F, G, H, I, J, K, L and M, respectively	New York Stock Exchange
Exchangeable Capital Securities, Series A	New York Stock Exchange
Non-Cumulative Dollar Preference Shares*	New York Stock Exchange
Dollar Perpetual Regulatory tier one securities, Series 1	New York Stock Exchange

* Issuable upon exchange of the Exchangeable Capital Securities

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

None

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

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

Ordinary shares of 25 pence each	3,172,605,080	Non-cumulative dollar preference shares, Series D to M	153,000,000
Non-voting Deferred Shares	2,660,556,304	Non-cumulative convertible dollar preference shares, Series 1 to 3	1,900,000
11% cumulative preference shares	500,000	Non-cumulative euro preference shares, Series 1	1,250,000
5½% cumulative preference shares	400,000	Non-cumulative convertible euro preference shares, Series 1	750,000
		Non-cumulative convertible sterling preference shares, Series 1	200,000

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

YES NO

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

Item 17 Item 18

SEC Form 20-F cross reference guide

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Operating and financial review

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Presentation of information

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

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

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

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

The Group distinguishes its trading from non-trading activities by determining whether a business unit's principal activity is trading or non-trading and then attributing all of that unit's activities to one portfolio or the other. Although this method may result in some non-trading activity being classified as trading, and vice versa, the Group believes that any resulting misclassification is not material.

In this report, the terms "UK GAAP" and "US GAAP" refer to generally accepted accounting principles ("GAAP") in the UK and the US, respectively.

Forward-looking statements

Certain sections in this document contain "forward-looking statements" as that term is defined in the United States Private Securities Litigation Reform Act of 1995, such as statements that include the words "expect", "estimate", "project", "anticipate", "believes", "should", "intend", "plan", "probability", "risk", "Value-at-Risk ("VaR")", "target", "goal", "objective", "will", "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 Group's potential exposures to various types of market risks, such as interest rate risk, foreign exchange rate risk and commodity and equity price risk. Such statements are subject to risks and uncertainties. For example, certain of the market risk disclosures are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market risk disclosures are only estimates and, as a result, actual future gains and losses could differ materially from those that have been estimated.

Other factors that could cause actual results to differ materially from those estimated by the forward-looking statements contained in this document include, but are not limited to: general economic conditions in the UK and in other countries in which the Group has significant business activities or investments, including the United States;

the monetary and interest rate policies of the Bank of England, the Board of Governors of the Federal Reserve System and other G-7 central banks; inflation; deflation; unanticipated turbulence in interest rates, foreign currency exchange rates, commodity prices and equity prices; changes in UK and foreign laws, regulations and taxes; changes in competition and pricing environments; natural and other disasters; the inability to hedge certain risks economically; the adequacy of loss reserves; acquisitions or restructurings; technological changes; changes in consumer spending and saving habits; and the success of the Group in managing the risks involved in the foregoing.

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

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

Operating and financial review

Description of business

Introduction

The Royal Bank of Scotland Group plc is the holding company of one of the world's largest banking and financial services groups, with a market capitalisation of £55.6 billion at the end of 2004. Headquartered in Edinburgh, the Group operates in the UK, US and internationally through its two principal subsidiaries, the Royal Bank and NatWest. Both the Royal Bank and NatWest are major UK clearing banks whose origins go back over 275 years. In the US, the Group's subsidiary, Citizens is ranked the eighth largest commercial banking organisation by deposits. The Group has a large and diversified customer base and provides a wide range of products and services to personal, commercial and large corporate and institutional customers.

The Group had total assets of £583 billion and ordinary shareholders' equity of £27.3 billion at 31 December 2004. It is strongly capitalised with a total capital ratio of 11.7% and tier 1 capital ratio of 7.0% as at 31 December 2004.

Organisational structure and business overview

The Group's activities are organised in the following business divisions: Corporate Banking and Financial Markets, Retail Banking, Retail Direct, Manufacturing, Wealth Management, RBS Insurance, Ulster Bank and Citizens. A description of each of the divisions is given below.

Corporate Banking and Financial Markets (CBFM) is the largest provider of banking services to medium and large businesses in the UK with growing presence in the US, Europe and Asia. It provides an integrated range of products and services including corporate and commercial banking, treasury and capital markets products, structured and leveraged finance, trade finance, leasing and factoring.

Within CBFM, Financial Markets provides corporate and institutional customers with treasury services, including global interest rate derivatives trading, bond origination and trading, sovereign debt trading, futures brokerage, foreign exchange, money market, currency derivative and rate risk management services. RBS Greenwich Capital, with headquarters in Connecticut, US, delivers debt market solutions tailored to meet the needs of companies and institutions around the world.

Retail Banking is one of the leading retail banks in the UK. The division comprises both the Royal Bank and NatWest retail brands. It offers a full range of banking products and related financial services to the personal, premium and small business markets.

In the personal banking market, Retail Banking offers a comprehensive product range: money transmission, savings, loans, mortgages and insurance. In the small business market, Retail Banking provides a full range of services which include money transmission and cash management, short, medium and long-term financing, deposit products and insurance.

Customer choice and product flexibility are central to the Retail Banking proposition and customers are able to access services through a full range of channels: branches, ATMs, the internet and the telephone.

Retail Direct consists of the Group's non-branch based retail businesses. Retail Direct issues a comprehensive range of credit, charge and debit cards to personal and corporate customers and provides merchant acquisition and processing facilities for retail businesses. It also includes Tesco Personal Finance (TPF), The One account, Direct Line Financial Services (DLFS), Lombard Direct, WorldPay Limited, the Group's internet banking platform, the Primeline brand and in Europe, the Comfort Card businesses, all of which offer products to customers through direct channels.

During 2004 Retail Direct expanded its international operations. In the US, it acquired the credit card business of People's Bank, Lynk systems Inc., a leading merchant acquirer and entered into an agreement to issue credit cards to the customers of Kroger, a leading supermarket chain. In continental Europe, Retail Direct acquired Bibit NV, a leading internet payment specialist and agreed to provide consumer finance services through the outlets of Tchibo, a leading German retailer.

Manufacturing supports the customer facing businesses in the UK and Ireland and manages the Group's telephony, account management and money transmission operations. It is also responsible for information technology operations and development, global purchasing, property and other services.

Manufacturing drives optimum efficiencies in high volume processing activities, leverages the Group's purchasing power and has become a centre of excellence for managing large scale and complex change programmes such as integration.

Wealth Management provides private banking and investment services to its clients through a number of leading UK and overseas private banking subsidiaries and offshore banking businesses. Coutts is one of the world's leading international wealth managers with over 50 offices worldwide, including Switzerland, Dubai, Monaco, Hong Kong and Singapore, as well as its premier position in the UK. Adam & Company is the major private bank in Scotland. The offshore banking businesses – The Royal Bank of Scotland International and NatWest Offshore – deliver retail banking services to local and expatriate customers, and corporate banking and treasury services to corporate, intermediary and institutional clients, principally in the Channel Islands, the Isle of Man and Gibraltar.

RBS Insurance is the second largest general insurer in the UK, by gross earned premiums. Through the Direct Line, Churchill and Privilege brands it sells and underwrites personal insurance over the telephone and the internet in the UK. Through the red phone brand, RBS Insurance also sells and

underwrites personal insurance in Spain, Italy and Germany. UKI Partnerships is a leading provider of insurance and motoring related services through partner brands, including through Tesco Personal Finance. NIG sells personal and commercial products through a network of intermediaries, while Inter Group acts as an insurance administrator and Devitt Insurance Services operates as a specialist broker administrator.

Ulster Bank provides a comprehensive range of retail and corporate banking services in Northern Ireland and the Republic of Ireland. In retail banking, Ulster Bank operates a network of branches throughout Ireland serving personal and commercial customers. Corporate Banking and Financial Markets provides a wide range of services in the corporate and institutional markets.

In January 2004 Ulster Bank acquired First Active plc, a leading provider of mortgages, retail savings and investment products in the Republic of Ireland. First Active and Ulster Bank have retained their own distinctive brands, branch networks and customer propositions, with efficiencies derived from shared central manufacturing activities.

Citizens is the second largest commercial banking organisation in New England and the eighth largest commercial banking organisation in the US measured by deposits. Citizens provides retail and corporate banking services under the Citizens brand in the states of Connecticut, Delaware, Massachusetts, New Hampshire, New Jersey, Pennsylvania and Rhode Island, and the Charter One brand in the states of Illinois, Indiana, Michigan, New York, Ohio and Vermont. Through its branch network Citizens provides a full range of retail and corporate banking services, including personal banking, residential mortgages and cash management. In addition, Citizens engages in a wide variety of commercial lending, consumer lending, commercial and consumer deposit products, merchant credit card services, insurance products, trust services and retail investment services.

During 2004, Citizens completed the acquisitions of Thistle Group Holdings, Co., the holding company of Roxborough Manayunk Bank and Charter One Financial Group, Inc., the holding company of Charter One Bank.

Competition

The Group faces intense competition in all the markets it serves. In the UK, the Group's principal competitors are the other UK retail and commercial banks, building societies (which are similar to savings and loans associations in the US) and the other major international banks represented in London.

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

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

In the personal banking segment the Group competes with UK banks and building societies, major retailers, life assurance companies and internet-only players. In the mortgage market where the Group competes with UK banks and building societies, re-mortgaging activity by customers has been at a high level. NatWest Life and Royal Scottish Assurance compete with Independent Financial Advisors and life assurance companies. The competitive situation in the long term savings market is dynamic due to the uncertainties created by regulatory change and continued evolution of institutions, particularly in the mutual sector.

In the UK credit card market large retailers and specialist card issuers, including major US operators, are active in addition to the UK banks and building societies. Competitive pressure includes aggressive pricing, loyalty and reward schemes, and packaged benefits. In addition to physical distribution channels, providers compete through direct marketing activity and, increasingly, the internet.

In Wealth Management, The Royal Bank of Scotland International and NatWest Offshore compete with other UK and international banks to offer offshore banking services. Coutts and Adam & Company compete as private banks with UK clearing and private banks, and with international private banks.

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

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

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

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

Operating and financial review continued

Risk factors

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

The financial performance of the Group is affected by borrower credit quality and general economic conditions, in particular in the UK, US and Europe

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

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

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

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

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

Operational risks are inherent in the Group's business

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

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

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

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

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

Critical accounting policies

The reported results of the Group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. The Group's principal accounting policies are set out on pages 85 to 88. UK company law and accounting standards require the directors, in preparing the Group's financial statements, to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent. Where UK GAAP allows a choice of policy, Financial Reporting Standard (FRS) 18 Accounting Policies requires an entity to adopt those policies judged to be most appropriate to its particular circumstances for the purpose of giving a true and fair view.

The judgements and assumptions involved in the Group's accounting policies that are considered by the Board to be the most important to the portrayal of its financial condition are discussed below. The use of estimates, assumptions or models that differ from those adopted by the Group would affect its reported results.

Provisions for bad and doubtful debts

The Group provides for losses existing in its lending book so as to state its loan portfolio at its expected ultimate net realisable value. Specific provisions are established against individual exposures and the general provision covers advances impaired at the balance sheet date but which have not been identified as such. Bad and doubtful debt provisions made during the year less amounts released and recoveries of amounts written-off in previous years are charged to the profit and loss account. Loans and advances are reported on the balance sheet net of specific and general provisions.

For certain homogeneous portfolios, including credit card receivables and other personal advances including mortgages, specific provisions are established on a portfolio basis, taking into account the level of arrears, security, past loss experience, credit scores and defaults based on portfolio trends. The most significant factors in establishing these provisions are the expected loss rates and the related average life. These factors are kept under constant review by the Group.

Other loans and advances are individually assessed and the specific provision is determined from a review of the financial condition of the borrower and any guarantor and takes into account the customer's debt capacity and financial flexibility; the level and quality of earnings; the amount and sources of cash flows; the industry in which the customer operates; and the realisable value of any security held. The most significant estimates that affect the quantum of a specific provision are the receipts from the borrower and the amount that will be recovered from any security held.

Evaluating these estimates involves significant judgement as receipts will depend on the future performance of the borrower and the value of security, both of which will be affected by future economic conditions. Additionally, the security may not be readily marketable.

The general provision covers bad and doubtful debts that have not been separately identified at the balance sheet date but are known to be present in any portfolio of advances. The level of general provision is assessed in the light of past experience and reflects the size and diversity of the Group's loan portfolio, the current state of the economies in which the Group operates, other factors affecting the business environment, recent trends in companies going into administration, receivership and bankruptcy and the Group's monitoring and control procedures, including the scope of specific provisioning procedures.

The future credit quality of the Group's lending book is subject to uncertainties that could cause actual credit losses to differ materially from reported loan loss provisions. These uncertainties include the economic environment, notably interest rates and their effect on customer spending, the unemployment level, payment behaviour and bankruptcy trends and changes in the Group's portfolios.

Loans and advances – recognition of interest income

Interest receivable from loans and advances is credited to the profit and loss account as it accrues unless there is significant doubt that it can be collected. If the collection of interest is in doubt, it is credited to a suspense account and excluded from interest receivable; it continues to be charged to the customer's account.

Pensions

The Group operates a number of defined benefit pension schemes as described in Note 3 on the financial statements. The assets of the schemes are measured at their fair value at the balance sheet date. Scheme liabilities are measured using the projected unit method, which takes account of projected earnings increases, using actuarial assumptions that give the best estimate of the future cash flows that will arise under the scheme liabilities. These cash flows are discounted at the interest rate applicable to high-quality corporate bonds of the same currency and term as the liabilities. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit). An asset is only recognised to the extent that the surplus can be recovered through reduced contributions in the future or through refunds from the scheme. In determining the value of scheme liabilities assumptions are made as to price inflation, dividend growth, pension increases, earnings growth and employees. There is a range of assumptions that could be adopted in valuing the schemes' liabilities. Different assumptions could significantly alter the amount of the deficit recognised in the balance sheet and the pension cost charged to the profit and loss account. The assumptions underlying the 2004 deficit and pension cost are set out in Note 3 on the financial statements.

Fair value

Securities and derivatives held for trading purposes are recognised in the financial statements at fair value. In the balance sheet, trading securities are included within Treasury and other eligible bills, Debt securities and Equity shares as appropriate. Positive fair values (assets) of trading derivatives are included in Other assets and negative fair values (liabilities) in Other liabilities. Positive and negative fair values of trading derivatives are offset where the contracts have been entered into under master netting agreements or other agreements that give a legally enforceable right of set-off. Gains or losses arising from changes in fair value are included in Dealing profits in the profit and loss account.

Fair value is the value at which a position could be closed out or sold in a transaction to a willing and knowledgeable counterparty over a reasonable period of time under current market conditions. Fair values are determined by reference to observable market prices where available and reliable. Where representative market prices for an instrument are not available or are unreliable because of poor liquidity, the fair value is derived from prices for its components using appropriate pricing or valuation models that are based on independently sourced market parameters, including interest rate yield curves, option volatilities and currency rates.

Operating and financial review continued

Securities carried at fair value include government, asset-backed and corporate debt obligations and corporate equity shares. Fair value for a substantial proportion of these instruments is based on observable market prices or derived from observable market parameters. Determining fair value for such instruments does not involve significant judgement. Where observable prices are not available or if a position could be liquidated only at an unfavourable price or over an extended period, fair value is based on appropriate valuation techniques or management estimates.

The Group's derivative products include swaps, forwards, futures and options. Exchange traded instruments are valued using quoted prices. The fair value of over-the-counter instruments is derived from pricing models which take account of contract terms, including maturity, as well as quoted market parameters such as interest rates and volatilities. Most of the Group's pricing models do not entail material subjectivity because the methodologies utilised do not incorporate significant judgement and the parameters included in the models can be calibrated to actively quoted market prices. Values established from pricing models are adjusted for credit risk, liquidity risk and future operational costs.

A negligible proportion of the Group's trading derivatives are valued directly from quoted prices, the majority being valued using appropriate valuation techniques. The fair value of substantially all securities positions carried at fair value is determined directly from quoted prices.

General insurance claims

The Group makes provision for the full cost of settling outstanding claims arising from its general insurance business at the balance sheet date, including claims estimated to have been incurred but not yet reported at that date and claims handling expenses. Claims are recognised in the accounting period in which the loss occurs.

Provisions are determined by management based on experience of claims settled and on statistical models which require certain assumptions to be made regarding the incidence, timing and amount of claims and any specific factors such as adverse weather conditions. In order to calculate the total provision required, the historical development of claims is analysed using statistical methodology to extrapolate, within acceptable probability parameters, the value of outstanding claims at the balance sheet date. Also included in the estimation of outstanding claims are other assumptions such as the inflationary factor used for bodily injury claims which is based on historical trends and, therefore, allows for some increase due to changes in common law and statute. Costs for both direct and indirect claims handling expenses are also included. Outward reinsurance recoveries are accounted for in the same accounting period as the direct claims to which they relate.

The outstanding claims provision is based on information available to management and the eventual outcome may vary from the original assessment. Actual claims experience may differ from the historical pattern on which the estimate is based and the cost of settling individual claims may exceed that assumed.

Goodwill

The Group capitalises goodwill arising on the acquisition of businesses, as disclosed in the Accounting policies. Goodwill is the excess of the cost of an acquisition and the fair value of its net assets. The determination of the fair value of assets and liabilities of businesses acquired requires the exercise of management judgement; for example those financial assets and liabilities for which there are no quoted prices, and those non-financial assets where valuations reflect estimates of market conditions such as property. Different fair values would result in changes to the goodwill arising and to the post-acquisition performance of the acquisition. Under UK GAAP goodwill is amortised and there is a rebuttable presumption that the useful economic life of purchased goodwill does not exceed 20 years from the date of acquisition. The useful economic life of acquired goodwill is assessed on the basis of the type and diversity of the business, its location and the markets in which it operates. Under US GAAP goodwill is not amortised but is subject to annual review for impairment.

An impairment test is designed to assess the recoverable amount of an asset or, in the case of goodwill, an operating segment, by comparing its carrying value with the discounted value of future cash flows that it will generate. Impairment testing inherently involves a number of judgmental areas: the preparation of cash flow forecasts for periods that are beyond the normal requirements of management reporting, the valuation of the separable assets of each business whose goodwill is being reviewed and an assessment of the discount rate appropriate to the business. Under UK GAAP, impairment tests are only undertaken in the year following an acquisition or when there is evidence that impairment might have occurred. US GAAP requires annual impairment tests that are different from any UK tests and accordingly they may support a different carrying value for the asset being tested.

Accounting developments

UK GAAP

UITF Abstract 38 [Accounting for ESOP trusts] and the consequential amendment to UITF Abstract 17 [Employee share schemes] which are applicable for the year ended 31 December 2004 did not have a material effect on the Group.

The Accounting Standards Board issued FRS 27 [Life Assurance] which introduces a new [realistic] method of measuring life assurance liabilities and related assets. The present value of in-force policies can continue to be recognised provided that future investment margins are not included. The standard is applicable under UK GAAP for years ending on or after 31 December 2005 and is not expected to have a material effect on the Group.

International Financial Reporting Standards

In June 2002, the European Union adopted a regulation that requires, from 1 January 2005, listed companies to prepare their financial statements in accordance with international accounting standards adopted by the EU. The Group's 2005 financial statements will therefore be prepared in accordance with International Financial Reporting Standards ([IFRS]). These comprise not only IFRS but also International Accounting Standards ([IAS]).

IFRS differ in certain significant respects from the Group's accounting policies under UK GAAP. The summary below outlines the important differences for the Group in respect of recognition and measurement on the basis of extant IFRS that will be effective for 2005, including revised IAS 32 and IAS 39:

Goodwill [IFRS require goodwill arising on the acquisition of subsidiaries or associates to be capitalised. Amortisation of goodwill is prohibited but it must be tested annually for impairment (and whenever changes in circumstances indicate impairment). Under the Group's UK GAAP accounting policy, goodwill arising on acquisitions

after 1998 is recognised as an asset and amortised on a straight-line basis over its useful economic life. Impairment tests are carried out at the end of the first full accounting period after its acquisition, and whenever there are indications of impairment. Goodwill arising on acquisitions before 1 October 1998 was deducted from reserves immediately. Certain amounts that would be included as goodwill under UK GAAP are recognised as intangibles under IFRS. Such intangibles are amortised over their useful lives unless they are regarded as having an indefinite useful life in which case they are not amortised but tested for impairment annually (and whenever changes in circumstances indicate impairment).

Merger accounting □ IFRS require all business combinations to be accounted for as acquisitions by applying the purchase method. UK GAAP requires business combinations meeting certain criteria to be accounted for using merger accounting.

Dividends □ IFRS require dividends payable to be recorded in the period in which they are declared whereas under UK GAAP dividends are recorded in the period to which they relate.

Computer software □ under UK GAAP, most software development costs are written off as incurred. Under IFRS, such costs are capitalised if certain conditions are met and amortised over the estimated useful life of the software.

Pensions □ the Group has implemented FRS 17 'Retirement Benefits' (FRS 17) for 2004. The measurement principles of this standard are similar to those required by IFRS. IFRS, like FRS 17, allow actuarial gains and losses to be recognised outside the profit and loss account. However IFRS allow as alternatives actuarial gains and losses to be recognised in profit or loss either in the period in which they occur or on a deferred basis.

Share-based payments □ under UK GAAP, no compensation expense is recognised for Inland Revenue approved Save-as-you-earn share option schemes or for other share option schemes where the option has no intrinsic value (i.e. where at date of grant the exercise price equals the market value). IFRS require the fair value of share options at the date of grant to be recognised as an expense

Financial instruments: financial assets □ under UK GAAP, loans are measured at cost less provisions for bad and doubtful debts, derivatives held for trading are carried at fair value and hedging derivatives are accounted for in accordance with the treatment of the item being hedged (see □Derivatives and hedging□ below), and securities are classified as being held as investment securities, or held for dealing purposes. Investment debt securities are stated at cost less provision for any permanent diminution in value. Premiums and discounts on dated securities are amortised to interest income over the period to maturity. Other securities are carried at fair value. Under IFRS, financial assets are classified into held-to-maturity; available-for-sale; held for trading; designated as fair value through profit or loss; and loans and receivables. Financial assets classified as held-to-maturity or as loans and receivables are carried at amortised cost. Other financial assets are measured at fair value. Changes in the fair value of available-for-sale financial assets are reported in a separate component of shareholders' equity. Changes in the fair value of financial assets held for trading or designated as fair value are taken to the profit and loss account. Financial assets can be classified as held-to-maturity only if they have a fixed maturity and the reporting entity has the positive intention and ability to hold to maturity. Trading financial assets are held for the purpose of selling in the near term. IFRS allow any financial asset to be designated as fair value through profit and loss on initial recognition. Unquoted debt financial assets that are not classified as held-to-maturity, held for trading or designated as fair value through profit or loss are categorised as loans and receivables. All other financial assets are classified as available-for-sale.

Effective interest rate and lending fees □ under UK GAAP, loan origination fees are recognised when receivable unless they are charged in lieu of interest. IFRS require origination fees to be deferred and recognised as an adjustment to the effective interest rate on the related financial asset. The effective interest rate is the rate that discounts estimated future cash flows over

Operating and financial review continued

an instrument's expected life to its net carrying value. It takes into account all fees and points paid that are an integral part of the yield, transaction costs and all other premiums and discounts. Under IFRS, the carrying value of a financial instrument held at amortised cost is calculated using the effective interest method.

Loan impairment – under UK GAAP, provisions for bad and doubtful debts are made so as to record impaired loans at their expected ultimate net realisable value. IFRS require impairment losses on financial assets carried at amortised cost to be measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. Impairment must be assessed individually for individually significant assets but can be assessed collectively for other assets.

Financial instruments: financial liabilities – IFRS require all financial liabilities to be measured at amortised cost except those held for trading and those that were designated as fair value through profit and loss on initial recognition. Under UK GAAP, short positions in securities and trading derivatives are carried at fair value, all other financial liabilities are recorded at amortised cost. In IFRS as adopted by the EU, the option to designate at fair value through profit and loss is not available.

Liabilities and equity – under UK GAAP, all issued shares are classified as shareholders' funds, and analysed between equity and non-equity interests. There is no concept of non-equity shares in IFRS. Instruments are classified between equity and liabilities in accordance with the substance of the contractual arrangements. A non-derivative instrument is classified as equity if it does not include a contractual obligation either to deliver cash or to exchange financial instruments with another entity under potentially unfavourable conditions, and if the instrument will or may be settled by the issue of equity, settlement does not involve the issue of a variable number of shares.

Derivatives and hedging – under UK GAAP, non-trading derivatives are accounted for on an accruals basis in accordance with the accounting treatment of the underlying transaction or transactions being hedged. If a non-trading derivative transaction is terminated or ceases to be an effective hedge, it is re-measured at fair value and any gain or loss amortised over the remaining life of the underlying transaction or transactions being hedged. If a hedged item is derecognised the related non-trading derivative is remeasured at fair value and any gain or loss taken to the profit and loss account. Under IFRS, all derivatives are measured at fair value. Hedge accounting is permitted for three types of hedge relationship: fair value hedge – the hedge of changes in the fair value of a recognised asset or liability or firm commitment; cash flow hedge – the hedge of variability in cash flows from a recognised asset or liability or a forecast transaction; and the hedge of a net investment in a foreign operation. In a fair value hedge the gain or loss on the derivative is recognised in the profit and loss account as it arises offset by the corresponding gain or loss on the hedged item attributable to the risk hedged.

In a cash flow hedge and in the hedge of a net investment in a foreign operation, the element of the derivative's gain or loss that is an effective hedge is recognised directly in equity. The ineffective element is taken to the profit and loss account. Certain conditions must be met for a relationship to qualify for hedge accounting. These include designation, documentation and prospective and actual hedge effectiveness.

Embedded derivatives – under IFRS, a derivative embedded in a contract must be accounted for separately from the host contract if the embedded derivative has economic characteristics that differ from those of the host contract. There is no equivalent requirement in UK GAAP.

Offset – for a financial asset and financial liability to be offset, IFRS require that an entity must intend to settle on a net basis or to realise the asset and settle the liability simultaneously. However, under UK GAAP an intention to settle net is not a requirement for set off, although the entity must have the ability to insist on net settlement and that ability is assured beyond doubt.

Leasing □ under UK GAAP, finance lease income is recognised so as to give a level rate of return on the net cash investment in the lease. IFRS require a level rate of return on the net investment in the lease. This means that under UK GAAP tax cash flows are taken into account in allocating income but they are not under IFRS.

Transition □ IFRS 1 □First-time Adoption of International Financial Reporting Standards□ (IFRS 1) will apply to the Group's 2005 financial statements. The standard requires an opening IFRS balance sheet to be prepared as at the date of transition to IFRS, being the beginning of the earliest comparative period presented under IFRS in its first IFRS financial statements (the transition date). Accounting policies must comply with each IFRS effective at the reporting date of the first IFRS financial statements, and applied throughout all periods presented.

In the opening balance sheet the entity:

- recognises all assets and liabilities whose recognition is required by IFRS, but not any assets or liabilities not permitted by IFRS to be recognised;
- reclassifies items recognised under previous GAAP in accordance with IFRS requirements;
- applies IFRS in measuring all recognised assets and liabilities.

IFRS 1 provides certain optional exemptions from the above principles:

- Business combinations □ past business combinations need not be restated in accordance with IFRS 3 □BusinessCombinations□.

- Fair value or revaluation as deemed cost □ the fair value of an item of property, plant or equipment, or a previous GAAP revaluation (that approximates fair value) of such an item, may be treated as though it were the cost basis for the asset, with subsequent depreciation and impairment based on that amount.
- Employee benefits □ under IAS 19 □Employee Benefits□, actuarial gains and losses on pension schemes may be unrecognised if they fall within a □corridor□. On first time application, an entity may determine the unrecognised gains and losses from inception of the pension scheme and recognise only those that would be recognised under IAS 19, or alternatively recognise all cumulative gains and losses at the transition date.
- Cumulative translation differences □ cumulative translation differences on the net investment in a foreign operation prior to the transition date need not be calculated but set at zero.
- Compound financial instruments □ split accounting required by IAS 39 need not be applied for a compound financial instrument if the liability component is no longer outstanding at the date of transition.
- Designation of financial instruments □ an entity is allowed to designate a financial instrument as financial asset or financial liability at fair value through profit or loss on the date of transition rather than on initial recognition as required by IAS 39.
- Share-based payment transactions □ IFRS 2 □Share-basedPayment□ must be applied to equity instruments granted on or after 7 November 2002 that had not vested before the later of the transition date and 1

January 2005.

IFRS 1 prohibits retrospective application of some aspects of IFRS:

- Derecognition of financial assets and financial liabilities – the derecognition requirements of IAS 39 are to be applied prospectively for transactions occurring on or after 1 January 2004. However, an entity is permitted to apply the derecognition requirements retrospectively from a date of its choice.
- Hedge accounting – at the transition date, all derivatives must be measured at fair value. Gains and losses deferred under previous accounting must be eliminated. Hedge accounting for relationships that do not qualify under IAS 39 must be discontinued in accordance with the hedge termination rules in IAS 39.
- Assets classified as held for sale and discontinued operations – entities with a transition date before 1 January 2005 must apply the transition rules in IFRS 5 – Non-current Assets Held for Sale and Discontinued Operations.

IFRS require at least one year of comparative data. However this data need not comply with IAS 32, IAS 39 and IFRS 4 – Insurance Contracts. If comparatives that do not comply with IAS 32, IAS 39 and IFRS 4 are presented, then the date of transition for these standards will be the beginning of the first IFRS reporting period.

US GAAP

For a discussion of recent developments in US GAAP relevant to the Group, see Note 53 on the accounts.

Operating and financial review continued

Financial highlights

for the year ended 31 December	2004 £m	2003* £m	2002* £m
Total income	22,754	19,281	17,016
Profit before tax	6,917	6,076	4,852
Profit attributable to ordinary shareholders	4,256	2,254	2,034
Cost:income ratio (%) (1)	47.7	49.4	55.6
Basic earnings per share (pence)	138.0	76.9	70.6
Dividend cover (times) (2)	2.3	1.5	1.6
Return on equity (%) (3)	16.0	9.8	8.8

at 31 December	2004 £m	2003* £m	2002* £m
Total assets	583,467	454,428	411,038
Loans and advances to customers	345,469	252,531	223,324
Deposits	384,143	304,286	273,881

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Shareholders' funds	31,865	26,098	25,071
Risk asset ratio - tier 1 (%)	7.0	7.4	7.3
- total (%)	11.7	11.8	11.7

Notes:

- (1) Cost:income ratio represents operating expenses expressed as a percentage of total income.
(2) Dividend cover represents the total ordinary dividend expressed as a multiple of profit attributable to ordinary shareholders.
(3) After-tax return on equity is based on profit attributable to ordinary shareholders and average equity shareholders' funds.

* restated (see page 85)

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Summary consolidated profit and loss account for the year ended 31 December 2004

	2004 £m	2003* £m	2002* £m
Net interest income	9,208	8,301	7,849
Dividend income	79	58	58
Fees and commissions receivable	6,634	5,693	5,249
Fees and commissions payable	(1,954)	(1,337)	(965)
Dealing profits	1,988	1,793	1,462
Other operating income	1,855	1,650	1,410
	8,602	7,857	7,214
General insurance			
- earned premiums	5,357	3,627	2,442
- reinsurance	(413)	(504)	(489)
Non-interest income	13,546	10,980	9,167
Total income	22,754	19,281	17,016
Operating expenses**	10,846	9,516	9,469
Profit before other operating charges	11,908	9,765	7,547
General insurance			
- gross claims	3,724	2,644	1,693
- reinsurance	(244)	(449)	(343)
Profit before provisions for bad and doubtful debts	8,428	7,570	6,197
Provisions for bad and doubtful debts	1,428	1,461	1,286
Amounts written off fixed asset investments	83	33	59

Profit on ordinary activities before tax	6,917	6,076	4,852
Tax on profit on ordinary activities	2,155	1,888	1,582
Profit on ordinary activities after tax	4,762	4,188	3,270
Minority interests (including non-equity)	250	210	133
Profit for the financial year	4,512	3,978	3,137
Preference dividends □ non-equity	256	261	305
	4,256	3,717	2,832
Additional Value Shares dividend □ non-equity	□□	1,463	798
Profit attributable to ordinary shareholders	4,256	2,254	2,034
Basic earnings per ordinary share	138.0p	76.9p	70.6p

* restated (see page 85)

** Integration costs included in operating expenses comprise:

	2004 £m	2003 £m	2002 £m
Administrative expenses	267	229	955
Depreciation	2	—	2
	269	229	957

Operating and financial review continued

2004 compared with 2003

Profit

Profit before tax was up 14%, from £6,076 million to £6,917 million.

The Group made a number of acquisitions during 2004 which had a bearing on the year's results. These included:

In January 2004, Ulster Bank completed the acquisition of First Active plc, for a cash consideration of €887 million.

In March 2004, RBS completed the purchase of the credit card business of People's Bank in the US.

In August 2004, Citizens completed the acquisition of Charter One Financial, Inc. for a cash consideration of US\$10.1 billion.

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The Group has adopted Financial Reporting Standard 17 "Retirement Benefits" (FRS 17) the standard that replaces SSAP24 "Pension Costs". The effect on prior years of adopting FRS 17 is shown on page 85.

Total income

The Group achieved strong growth in income during 2004. Total income was up 18% or £3,473 million to £22,754 million. Excluding acquisitions and at constant exchange rates, total income was up by 11%, £2,004 million.

Net interest income increased by 11% to £9,208 million and represents 40% of total income (2003 43%). Excluding acquisitions and at constant exchange rates, net interest income was up 8%. Average loans and advances to customers and average customer deposits grew by 19% and 10% respectively.

Non-interest income increased by 23% to £13,546 million and represents 60% of total income (2003 57%). Excluding acquisitions and at constant exchange rates, non-interest income was up 13%. There was good growth in transmission income and other fees, up 17% while general insurance premium income increased by 58%, reflecting organic growth and the acquisition of Churchill in September 2003. Gross income from rental assets grew by 18%, reflecting strong growth in operating lease assets.

Net interest margin

The Group's net interest margin at 2.92% was in line with expectations. Excluding the acquisition of First Active, the Group's net interest margin was down 0.03% from 2.97% in 2003, principally as a result of strong organic growth in mortgage lending and the increased funding cost of rental assets, the income from which is included in other income.

Operating expenses

Operating expenses rose by 14% to £10,846 million to support the strong growth in business volumes. Included in operating expenses are integration costs which in 2004 were £269 million principally relating to the integration of Churchill and the acquisitions by Citizens.

Cost:income ratio

The Group's ratio of operating expenses to total income improved further to 47.7% from 49.4%.

Net insurance claims

General insurance claims, after reinsurance, increased by 59% to £3,480 million. Excluding Churchill, the increase was 20%, consistent with volume growth and business mix.

Provisions

The profit and loss charge for bad and doubtful debts and amounts written off fixed asset investments was £1,511 million compared with £1,494 million in 2003. The charge for provisions in 2004 represented 0.41% of gross loans and advances to customers, compared with 0.57% in 2003.

Credit quality

Credit quality remains strong with no material change during 2004 in the distribution by grade of the Group's total risk assets.

The ratio of risk elements in lending to gross loans and advances to customers improved to 1.58% (2003 2.01%). Risk elements in lending and potential problem loans represented 1.66% of gross loans and advances to customers (2003 2.24%).

Provision coverage of risk elements in lending and potential problem loans improved to 73% (2003 68%).

Earnings and dividends

Basic earnings per ordinary share increased by 79%, from 76.9p to 138.0p. The final dividend on the Additional Value Shares paid in December 2003 reduced earnings per ordinary share for that year by 49.9p.

A final dividend of 41.2p per ordinary share is recommended, making a total for the year of 58.0p per share, an increase of 15%. If approved, the final dividend will be paid on 3 June 2005 to shareholders registered on 11 March 2005. The total dividend is covered 2.3 times by earnings.

Balance sheet

Total assets were £583 billion at 31 December 2004, 28% higher than total assets of £454 billion at 31 December 2003.

Lending to customers, excluding repurchase agreements and stock borrowing (□reverse repos□), increased in 2004 by 28% or £64.8 billion to £293.3 billion. Excluding acquisitions and reverse repos, lending increased by 18%. Customer deposits, excluding repurchase agreements and stock lending (□repos□), grew in 2004 by 16% or £33.0 billion to £242.9 billion. Excluding acquisitions and repos, deposits increased by 7%.

Although the adoption of FRS 17 has reduced shareholders' funds by £3,220 million (2003 □ £2,001 million), this has no effect on the Group's regulatory capital at 31 December 2004.

Capital ratios at 31 December 2004 were 7.0% (tier 1) and 11.7% (total), against 7.4% (tier 1) and 11.8% (total) at 31 December 2003.

Profitability

The after-tax return on ordinary equity improved from 9.8% to 16.0%. This is based on profit attributable to ordinary shareholders and average ordinary equity.

2003 compared with 2002

Profit

Profit before tax was up 25%, from £4,852 million to £6,076 million.

Total income

The Group achieved strong growth in income during 2003. Total income was up 13% or £2,265 million to £19,281 million. Non-interest income accounted for 57% of total income. Excluding acquisitions, total income rose by 10%.

Net interest income increased by 6% to £8,301 million and represented 43% of total income (2002 □ 46%). Average loans and advances to customers and average customer deposits grew by 12% and 8% respectively. The benefit of this growth more than offset the impact on net interest income of the Competition Commission inquiry into SME banking in the UK and the lower interest rate environment in the UK and the US which reduced income earned from deposits and investments.

Non-interest income increased by 20% to £10,980 million and represented 57% of total income (2002 □ 54%). Fees receivable were up 8% with good growth in lending, transmission and card related fees reflecting higher volumes. General insurance premium income grew strongly, reflecting volume growth in both motor and home insurance products, and the acquisition of Churchill. In addition, volumes in financial markets were up strongly in both the UK and the US reflecting growth in customer-driven activity in interest rate protection, mortgage securitisation and foreign exchange. Income from rental assets grew by 17% to £1,088 million, reflecting the growth in operating leases and investment properties.

Net interest margin

The Group's net interest margin at 2.97% was, in line with the first half, down from 3.13% in 2002 due to a reduced benefit from interest-free funds arising from the lower interest rate environment, and the outcome of the Competition Commission inquiry into SME banking.

Operating expenses

Operating expenses rose by 1% to £9,516 million. Included in operating expenses are integration costs which in 2003 were £229 million, of which, £143 million related to the final elements of the NatWest integration and £86 million related to other acquisitions, including Citizens' acquisitions and Churchill. All integration initiatives in relation to NatWest have been implemented. The programme benefits, comprising £890 million annual revenue benefits and £1,440 million annual cost savings, were fully implemented less than three years after the acquisition of NatWest. Total costs for the integration programme were £2.3 billion. Since 6 March 2000 the integration initiatives have contributed a cumulative £5.6 billion to the Group.

Cost:income ratio

The strong growth in income together with tight cost management resulted in a further improvement in the Group's ratio of operating expenses to total income, to 49.4% from 55.6%.

Net insurance claims

General insurance claims, after reinsurance, increased by 63% to £2,195 million. Excluding Churchill, the increase was 29%, consistent with volume growth in the component parts of the insurance division.

Provisions

The profit and loss charge for bad debts and amounts written off fixed asset investments was £1,494 million compared with £1,345 million in 2002. The profit and loss charge is in line with the growth in loans and advances.

Credit quality

There was no material change during the year in the distribution by grade of the Group's total risk assets.

The ratio of risk elements in lending to gross loans and advances to customers at 2.01% at 31 December 2003 showed an improving trend (31 December 2002 □ 2.14%).

Risk elements in lending and potential problem loans represented 2.24% of gross loans and advances to customers compared with 2.66% at 31 December 2002.

Operating and financial review continued

Earnings and dividends

Basic earnings per ordinary share increased by 9%, from 70.6p to 76.9p.

The final dividend of 55p per share amounting to £1.5 billion was paid on 1 December 2003 to the holders of the AVS issued in connection with the acquisition of NatWest. A total of £1 per AVS amounting to £2.7 billion in aggregate was paid over three years to shareholders in accordance with the original schedule.

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The total ordinary dividend for the year was 50.3p per ordinary share an increase of 15%. The total dividend was covered 1.5 times by earnings.

Balance sheet

Total assets were £454 billion at 31 December 2003, 11% higher than total assets of £411 billion at 31 December 2002.

Lending to customers, excluding repurchase agreements and stock borrowing (□reverse repos□), increased by 13% or £27 billion to £228 billion. Customer deposits, excluding repurchase agreements and stock lending (□repos□), grew by 8% or £16 billion to £210 billion.

Capital ratios at 31 December 2003 were 7.4% (tier 1) and 11.8% (total), against 7.3% (tier 1) and 11.7% (total) at 31 December 2002.

Profitability

The after-tax return on ordinary equity was 9.8% compared with 8.8% for 2002. This is based on profit attributable to ordinary shareholders and average equity shareholders□ funds.

Acquisitions

In January 2003, Citizens completed the acquisition of Pennsylvania-based commercial bank, Commonwealth Bancorp, Inc. for a cash consideration of US\$450 million.

In April 2003, Citizens announced the acquisition of Port Financial Corp., the holding company of the Massachusetts savings bank, CambridgePort Bank for a cash consideration of US\$285 million. This transaction was completed on 31 July 2003.

In May 2003, RBS announced the acquisition of Nordisk Renting AB, a Swedish leasing company, for a cash consideration of €104 million. This transaction was completed on 2 June 2003.

In May 2003, RBS announced the acquisition of the credit card and personal loans portfolios of Frankfurt-based Santander Direkt Bank for a cash consideration of €486 million. This transaction was completed on 31 July 2003.

In June 2003, RBS announced the acquisition of Churchill Insurance Group PLC for a cash consideration of £1.1 billion. This transaction was completed on 1 September 2003.

In July 2003, Citizens announced the acquisition of Community Bancorp, Inc., the holding company for Community National Bank, for a cash consideration of US\$116 million. This transaction was completed on 31 October 2003.

In September 2003, Citizens announced the acquisition of Thistle Group Holdings, Co., the holding company for Roxborough Manayunk Bank, for a cash consideration of US\$136 million. This transaction was completed on 5 January 2004.

In October 2003, Coutts Bank (Switzerland) Limited announced the acquisition of a Swiss private bank, Bank von Ernst & Cie AG, for a cash consideration of Swiss Francs 500 million. This transaction was completed on 28 November 2003.

In October 2003, RBS announced that it had agreed terms for a recommended acquisition of First Active plc, for a cash consideration of €887 million. This transaction was completed on 5 January 2004.

On 3 February 2004, RBS announced that it had agreed terms with People□s Bank of Connecticut to purchase their credit card portfolio. This transaction was completed on 5 March 2004.

Disposals

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In May 2003, RBS announced the sale of the Miami-based Latin American private banking operations of Coutts Group to Santander Central Hispano. The cash consideration was US\$81 million. This transaction was completed on 31 July 2003.

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Analysis of results

Net interest income	2004 £m	2003 £m	2002 £m
Interest receivable	16,696	13,998	13,561
Interest payable	(7,488)	(5,697)	(5,712)
Net interest income	9,208	8,301	7,849
	%	%	%
Gross yield on interest-earning assets of the banking business	5.30	5.00	5.41
Cost of interest-bearing liabilities of the banking business	(2.70)	(2.32)	(2.70)
Interest spread of the banking business	2.60	2.68	2.71
Benefit from interest-free funds	0.32	0.29	0.42
Net interest margin of the banking business	2.92	2.97	3.13
	%	%	%
Gross yield			
Group	5.30	5.00	5.41
UK	5.70	5.20	5.56
Overseas	4.38	4.44	4.97
Interest spread			
Group	2.60	2.68	2.71
UK	2.68	2.68	2.72
Overseas	2.48	2.71	2.69
Net interest margin			
Group	2.92	2.97	3.13
UK	2.96	2.95	3.14
Overseas	2.83	3.02	3.09
The Royal Bank of Scotland plc base rate	4.38	3.69	4.00
London inter-bank three month offered rates:			
Sterling	4.64	3.74	4.06
Eurodollar	1.62	1.22	1.80
Euro	2.11	2.33	3.32

Notes:

- (1) Gross yield is the interest rate earned on average interest-earning assets of the banking business.
- (2) Interest spread is the difference between the gross yield and the interest rate paid on average interest-bearing liabilities of the banking business.
- (3) Net interest margin is net interest income of the banking business as a percentage of average interest-earning assets of the banking business.

2004 compared with 2003

Group □ The net interest margin decreased from 2.97% to 2.92%. The interest spread declined reflecting principally a change in mix towards relatively lower margin mortgage business including the acquisition of First Active. This was partially offset by an increase in the benefit from interest-free funds due to increased volumes and movements in interest rates.

UK □ The UK net interest margin increased slightly from 2.95% to 2.96%. An increase in the benefit from interest-free funds, due to movements in interest rates, and improvements in corporate lending margins were largely offset by growth in the mortgage business.

Overseas □ The Overseas net interest margin decreased from 3.02% to 2.83%. This reduction reflected the continued tightening of asset spreads in the US, together with the growth in mortgage business following the acquisition of First Active. Higher volumes together with movements in interest rates led to an increase in the benefit of interest-free funds.

2003 compared with 2002

Net interest income increased by 6%, £452 million, to £8,301 million. Average interest-earning assets of the Group's banking business increased by 12%, £29.1 billion, to £279.7 billion. Within this, average loans and advances to customers were up 12%, £23.3 billion, to £213.3 billion due to growth in both corporate and personal lending.

Interest spread for the Group as a whole decreased from 2.71% to 2.68%. Interest-free balances fell partly due to the outcome of the Competition Commission inquiry into SME banking. This, together with the lower interest rate environment contributed to the reduction in the benefit of interest-free funds from 0.42% to 0.29% giving a decline in net interest margin from 3.13% to 2.97%.

UK □ Interest spread decreased from 2.72% to 2.68% with product margins remaining stable despite growth in the relatively lower margin mortgage business. The reduced benefit of interest-free funds due to the rate and volume impact described above resulted in the decrease in net interest margin from 3.14% to 2.95%.

Overseas □ Interest spread increased from 2.69% to 2.71%. Asset spreads tightened in the US due to lower interest rates; however, this was more than offset by overall mix and volume improvements elsewhere. Lower interest rates led to a reduction in the benefit from interest-free funds, resulting in the decline in net interest margin from 3.09% to 3.02%.

Operating and financial review continued

Average balance sheet and related interest

2004

2003*

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	Average balance £m	Interest £m	Rate %	Average balance £m	Interest £m	Rate %
Assets						
Treasury and other eligible bills □ UK	835	34	4.07	1,378	48	3.48
□ Overseas	62	1	1.61	64	1	1.56
Loans and advances to banks □ UK	13,528	527	3.90	13,724	459	3.34
□ Overseas	9,189	264	2.87	9,559	212	2.22
Loans and advances to customers □ UK	184,837	11,152	6.03	168,390	9,519	5.65
□ Overseas	69,118	3,201	4.63	44,862	2,240	4.99
Debt securities □ UK	19,549	756	3.87	23,810	754	3.17
□ Overseas	18,132	761	4.20	17,927	765	4.27
Total interest-earning assets □ banking business						
	315,250	16,696	5.30	279,714	13,998	5.00
□ trading business (3)						
	133,353			96,648		
Total interest-earning assets	448,603			376,362		
Non-interest-earning assets	70,510			66,060		
Total assets						
	519,113			442,422		
Percentage of assets applicable to overseas operations	33.1%			32.4%		
Liabilities and shareholders' equity						
Deposits by banks □ UK	35,059	1,060	3.02	28,220	703	2.49
□ Overseas	16,425	398	2.42	9,565	218	2.28
Customer accounts: demand deposits □ UK	67,519	1,569	2.32	64,469	1,028	1.59
□ Overseas	11,580	147	1.27	9,166	70	0.76
Customer accounts: savings deposits □ UK	24,147	673	2.79	18,653	503	2.70
□ Overseas	18,349	252	1.37	16,310	260	1.59
Customer accounts: other time deposits □ UK	51,591	1,712	3.32	49,880	1,478	2.96
□ Overseas	20,725	479	2.31	16,642	374	2.25
Debt securities in issue □ UK	37,097	1,229	3.31	29,977	914	3.05
□ Overseas	12,320	229	1.86	9,630	119	1.24
Loan capital □ UK	17,959	665	3.70	15,342	534	3.48
□ Overseas	235	15	6.38	154	16	10.39
Internal funding of trading business □ UK	(35,317)	(920)	2.60	(21,258)	(497)	2.34
□ Overseas	(758)	(20)	2.64	(1,651)	(23)	1.39
Total interest-bearing liabilities □ banking business						
	276,931	7,488	2.70	245,099	5,697	2.32
□ trading business (3)						
	131,743			93,466		

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Total interest-bearing liabilities	408,674	338,565
Non-interest-bearing liabilities		
Demand deposits □ UK	17,765	17,589
□ Overseas	9,101	7,330
Other liabilities	53,726	52,810
Shareholders' funds □ equity	26,538	22,973
□ non-equity	3,309	3,155
Total liabilities and shareholders' equity	519,113	442,422
Percentage of liabilities applicable to overseas operations	30.6%	30.6%

* restated (see page 85)

Notes:

- (1) The analysis into UK and Overseas has been compiled on the basis of location of office.
- (2) Loans and advances to customers include non-accrual loans. Interest income includes income on non-accruing loans only to the extent cash payments have been received.
- (3) Interest receivable and interest payable on trading assets and liabilities are included in dealing profits.

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	2002*		
	Average balance £m	Interest £m	Rate %
Assets			
Treasury and other eligible bills □ UK	910	24	2.64
□ Overseas	351	6	1.71
Loans and advances to banks □ UK	13,439	532	3.96
□ Overseas	9,811	304	3.10
Loans and advances to customers □ UK	154,202	9,141	5.93
□ Overseas	35,759	1,963	5.49
Debt securities □ UK	17,950	675	3.76
□ Overseas	18,188	916	5.04
Total interest-earning assets □ banking business	250,610	13,561	5.41
□ trading business (3)	78,380		
Total interest-earning assets	328,990		
Non-interest-earning assets	64,867		
Total assets	393,857		

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Percentage of assets applicable to overseas operations	32.0%		
<hr/>			
Liabilities and shareholders' equity			
Deposits by banks	21,090	544	2.58
UK			
Overseas	9,058	215	2.37
Customer accounts: demand deposits	58,618	1,062	1.81
UK			
Overseas	8,275	99	1.20
Customer accounts: savings deposits	16,002	463	2.89
UK			
Overseas	11,742	229	1.95
Customer accounts: other time deposits	45,902	1,542	3.36
UK			
Overseas	16,264	462	2.84
Debt securities in issue	24,154	965	4.00
UK			
Overseas	8,693	209	2.40
Loan capital	13,154	640	4.87
UK			
Overseas	166	17	10.24
Internal funding of trading business	(20,129)	(709)	3.52
UK			
Overseas	(1,301)	(26)	2.00
<hr/>			
Total interest-bearing liabilities	211,688	5,712	2.70
banking business			
trading business (3)	75,059		
<hr/>			
Total interest-bearing liabilities	286,747		
Non-interest-bearing liabilities			
Demand deposits	21,848		
UK			
Overseas	6,401		
Other liabilities	52,047		
Shareholders' funds	23,075		
equity			
non-equity	3,739		
<hr/>			
Total liabilities and shareholders' equity	393,857		
<hr/>			
Percentage of liabilities applicable to overseas operations	30.4%		

* restated (see page 85)

Notes:

- (1) The analysis into UK and Overseas has been compiled on the basis of location of office.
- (2) Loans and advances to customers include non-accrual loans. Interest income includes income on non-accruing loans only to the extent cash payments have been received.
- (3) Interest receivable and interest payable on trading assets and liabilities are included in dealing profits.

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.

	2004 over 2003			2003 over 2002		
	Increase/(decrease) due to changes in:			Increase/(decrease) due to changes in:		
	Average volume £m	Average rate £m	Net change £m	Average volume £m	Average rate £m	Net change £m
Interest-earning assets						
Treasury and other eligible bills						
UK	(21)	7	(14)	15	9	24
Overseas	□□	□□	□□	(5)	□□	(5)
Loans and advances to banks						
UK	(7)	75	68	11	(84)	(73)
Overseas	(8)	60	52	(8)	(84)	(92)
Loans and advances to customers						
UK	967	666	1,633	820	(442)	378
Overseas	1,133	(172)	961	467	(190)	277
Debt securities						
UK	(148)	150	2	196	(117)	79
Overseas	9	(13)	(4)	(13)	(138)	(151)
Total interest receivable of the banking business						
UK	791	898	1,689	1,042	(634)	408
Overseas	1,134	(125)	1,009	441	(412)	29
	1,925	773	2,698	1,483	(1,046)	437
Interest-bearing liabilities						
Deposits by banks						
UK	(190)	(167)	(357)	(179)	20	(159)
Overseas	(166)	(14)	(180)	(12)	9	(3)
Customer accounts: demand deposits						
UK	(51)	(490)	(541)	(101)	135	34
Overseas	(22)	(55)	(77)	(10)	39	29
Customer accounts: savings deposits						
UK	(153)	(17)	(170)	(72)	32	(40)
Overseas	(30)	38	8	(78)	47	(31)
Customer accounts: other time deposits						
UK	(51)	(183)	(234)	(128)	192	64
Overseas	(95)	(10)	(105)	(10)	98	88
Debt securities in issue						
UK	(232)	(83)	(315)	(205)	256	51
Overseas	(39)	(71)	(110)	(20)	110	90
Loan capital						

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UK	(96)	(35)	(131)	(96)	202	106
Overseas	(7)	8	1	1	□□	1
Internal funding of trading business						
UK	362	61	423	38	(250)	(212)
Overseas	(17)	14	(3)	6	(9)	(3)
Total interest payable of the banking business						
UK	(411)	(914)	(1,325)	(743)	587	(156)
Overseas	(376)	(90)	(466)	(123)	294	171
	(787)	(1,004)	(1,791)	(866)	881	15
Movement in net interest income						
UK	380	(16)	364	299	(47)	252
Overseas	758	(215)	543	318	(118)	200
	1,138	(231)	907	617	(165)	452

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Non-interest income	2004 £m	2003* £m	2002* £m
Dividend income	79	58	58
Fees and commissions receivable	6,634	5,693	5,249
Fees and commissions payable	(1,954)	(1,337)	(965)
Dealing profits	1,988	1,793	1,462
Other operating income	1,855	1,650	1,410
	8,602	7,857	7,214
General insurance premium income			
Earned premiums	5,357	3,627	2,442
Reinsurance	(413)	(504)	(489)
	4,944	3,123	1,953
	13,546	10,980	9,167

Note:

* FRS 17 restatements are detailed on page 85. In addition, certain income has been re-classified from net fees and commissions to insurance premium income in order to conform the accounting policies of Direct Line and Churchill.

2004 compared with 2003

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Non-interest income increased by £2,566 million, 23% to £13,546 million and represents 60% of total income (2003 □57%). Excluding acquisitions and at constant exchange rates, non-interest income was up 13%.

Within non-interest income, fees and commissions receivable increased by 17% or £941 million, to £6,634 million. This reflected strong growth in lending, transmission and card related fees together with increased insurance brokerage and ATM income.

Fees and commissions payable increased by £617 million to £1,954 million reflecting higher brokerage costs in CBFM due to greater volumes of trading and structuring business and fees paid in Retail Direct in support of higher volumes. Commissions payable to brokers and intermediaries in the general insurance business were up reflecting the acquisition of Churchill in September 2003.

Dealing profits at £1,988 million were up £195 million, 11% on 2003. Growth was achieved across all customer segments and product classes with further diversification of dealing revenues in the US to compensate for lower residential refinancing volume than the previous year.

Other operating income increased by 12% to £1,855 million. This was principally due to higher gross income from rental assets reflecting strong growth in operating lease assets.

General insurance premium income, after reinsurance, rose by 58%, or £1,821 million to £4,944 million reflecting organic growth and the acquisition of Churchill. Excluding Churchill, the growth was 17% reflecting volume growth in motor and home insurance products.

2003 compared with 2002

Non-interest income increased by 20%, or £1,813 million, to £10,980 million. Non-interest income represented 57% of total income. Excluding general insurance premium income, non-interest income rose by 9% or £643 million to £7,857 million reflecting strong performances in CBFM, up 18% or £670 million and Retail Direct, up 17%, or £145 million.

Within non-interest income, fees and commissions receivable increased by 8% or £444 million, to £5,693 million. This reflected an increase in lending and transmission fees, and good growth in insurance brokerage, cards related fees and ATM income.

Fees and commissions payable increased by £372 million to £1,337 million reflecting higher brokerage costs in CBFM, fees paid in Retail Direct in support of higher volumes and commissions payable to brokers and intermediaries following the acquisition of Churchill.

Dealing profits at £1,793 million were up £331 million, 23% on 2002. This reflected strong growth in volumes in all product areas. The performance in the first half of the year benefited from the unusually high levels of demand for mortgage backed securities in the US.

Other operating income increased by 17% to £1,650 million. This was due to growth in income from rental assets (comprising operating lease assets and investment properties) and higher investment securities gains.

General insurance premium income, after reinsurance, rose by 60%, or £1,170 million to £3,123 million. Excluding the acquisition of Churchill Insurance the growth was 25% or £490 million reflecting volume growth in motor and home insurance products.

Operating and financial review continued**Operating expenses***

	2004 £m	2003** £m	2002** £m
Administrative expenses:			
Staff costs	5,344	4,653	4,584
Premises and equipment	1,184	1,073	1,006
Other administrative	2,296	2,108	2,253
Total administrative expenses	8,824	7,834	7,843
Depreciation and amortisation	2,022	1,682	1,626
	10,846	9,516	9,469

* includes integration costs (see page 23)

** restated (see page 85)

2004 compared with 2003

Operating expenses rose by 14% to £10,846 million to support the strong growth in business volumes.

Staff costs were up £691 million, 15% to £5,344 million reflecting acquisitions, business growth and higher pension costs following the implementation of FRS 17. The number of staff increased by 15,700, 13% to 136,600. Of the increase 10,500 was due to acquisitions.

Premises and equipment expenses increased by £111 million, 10% to £1,184 million reflecting investment to upgrade the property portfolio in major UK centres to support the core business.

The increase in other administrative expenses reflected business volume growth and continued expenditure in support of Group wide projects.

The Group's ratio of operating expenses to total income improved further to 47.7% from 49.4%.

2003 compared with 2002

Operating expenses rose by 1% or £47 million to £9,516 million. This increased expenditure was in support of strong organic growth and customer service improvements.

Staff costs were up £69 million, to £4,653 million reflecting acquisitions and business growth. The number of staff increased by 9,100, 8% to 120,900. Acquisitions in the year added 9,700 staff of which 8,500 related to Churchill.

Premises and equipment expenses increased by £67 million, 7% to £1,073 million reflecting the continuing upgrade of the property portfolio in major UK centres to support the core business.

The increase in other administrative expenses reflected higher business volumes and included expenditure in support of Group wide projects.

Continued income growth coupled with a rigorous approach to cost management further improved the Group's cost:income ratio, to 49.4% from 55.6%.

Integration costs (included in operating expenses)

	2004 £m	2003 £m	2002 £m
Staff costs	113	125	530
Premises and equipment	34	31	127
Other administrative expenses	120	73	298
Depreciation of tangible fixed assets	2	□	2
	269	229	957

Integration costs in 2004 comprise £87 million relating to the integration of Churchill, £91 million relating to the integration of Charter One and £91 million in respect of other acquisitions.

Integration costs in 2003 comprise £143 million relating to the integration of NatWest, £63 million relating to the integration of Citizens' acquisitions and £23 million in respect of other acquisitions.

Integration costs in 2002 comprise £810 million relating to the integration of NatWest and £147 million relating to the integration of Citizens' acquisitions.

Accruals in relation to integration costs are set out below.

	At 31 December 2003 £m	Currency translation adjustments £m	Charge to profit and loss account £m	Utilised during the year £m	At 31 December 2004 £m
Staff costs □ redundancy	19	□	19	(27)	11
Staff costs □ other	27	(1)	94	(91)	29
Premises and equipment	2	(1)	34	(22)	13
Other	33	(2)	122	(109)	44
	81	(4)	269	(249)	97

Operating and financial review continued**Provisions**

2004 £m	2003 £m	2002 £m
------------	------------	------------

New provisions	1,658	1,566	1,408
less: recoveries of amounts previously written off	(147)	(72)	(63)
Charge to profit and loss account	1,511	1,494	1,345
Comprising:			
Provisions for bad and doubtful debts	1,428	1,461	1,286
Amounts written off fixed asset investments	83	33	59
Charge to profit and loss account	1,511	1,494	1,345

2004 compared with 2003

New provisions were up 6%, £92 million to £1,658 million. Recoveries of amounts previously written more than doubled to £147 million. Consequently the net charge to the profit and loss account was up £17 million, 1% to £1,511 million.

Bad debt provisions amounted to £1,428 million compared with £1,461 million in 2003, a decrease of 2%. Amounts written off fixed asset investments were up from £33 million in 2003 to £83 million.

Total balance sheet provisions for bad and doubtful debts amounted to £4,228 million compared with £3,929 million at 31 December 2003. Total provision coverage (the ratio of total balance sheet provisions to total risk elements in lending) remained stable at 76%.

The ratio of total balance sheet provisions to total risk elements in lending and potential problem loans increased to 73% compared with 68% at 31 December 2003.

2003 compared with 2002

New provisions were up 11%, £158 million to £1,566 million. Recoveries of amounts previously written off were up £9 million, 14%, to £72 million. Consequently the net charge to the profit and loss account was up £149 million, 11% to £1,494 million.

Bad debt provisions amounted to £1,461 million compared with £1,286 million in 2002, an increase of 14%. The increased charge was in line with the growth in lending during 2003. Amounts written off fixed asset investments, largely in the second half of the year, were down £26 million to £33 million compared with £59 million in 2002.

Total balance sheet provisions for bad and doubtful debts amounted to £3,929 million compared with £3,927 million at 31 December 2002. Total provision coverage (the ratio of total balance sheet provisions to total risk elements in lending) was 76% compared with 80% at 31 December 2002.

The ratio of total balance sheet provisions to total risk elements in lending and potential problem loans increased to 68% compared with 65% at 31 December 2002.

Taxation

	2004 £m	2003* £m	2002* £m
Tax on profit on ordinary activities	2,155	1,888	1,582
	%	%	%
UK corporation tax rate	30.0	30.0	30.0

Effective tax rate	31.2	31.1	32.6
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The actual tax charge differs from the expected tax charge computed by applying the standard rate of UK corporation tax as follows:

	2004 £m	2003* £m	2002* £m
Expected tax charge	2,075	1,823	1,456
Goodwill amortisation	241	200	183
Contributions to employee share schemes	(32)	(35)	(40)
Non-deductible items	227	248	179
Non-taxable items	(251)	(207)	(188)
Capital allowances in excess of depreciation	(415)	(626)	(340)
Other	45	16	6
Adjustments in respect of prior periods	(168)	(77)	(15)
Current tax charge for year	1,722	1,342	1,241
Deferred taxation:			
Origination and reversal of timing differences	482	581	397
Adjustments in respect of prior periods	(49)	(35)	(56)
Actual tax charge	2,155	1,888	1,582

* restated (see page 85)

Divisional performance

The contribution of each division before goodwill amortisation and integration costs and, where appropriate, Manufacturing costs is detailed below.

	2004 £m	2003 £m	2002 £m
Corporate Banking and Financial Markets	4,265	3,620	3,261
Retail Banking*	3,279	3,170	3,074
Retail Direct*	1,040	881	708
Manufacturing*	(2,439)	(2,114)	(1,952)
Wealth Management*	468	402	407
RBS Insurance*	862	609	456
Ulster Bank*	468	354	318
Citizens	1,037	857	766
Central items**	(879)	(711)	(498)
Profit before goodwill amortisation and integration costs	8,101	7,068	6,540
Goodwill amortisation	915	763	731
Integration costs	269	229	957

Profit on ordinary activities before tax	6,917	6,076	4,852
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* prior periods have been restated to reflect the transfer in 2004 of certain activities from Wealth Management to Retail Banking and from other divisions, principally RBS Insurance and Ulster Bank, to Manufacturing.

** restated following the implementation of FRS 17

The performance of each of the divisions is reviewed on pages 26 to 37.

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Operating and financial review continued

Corporate Banking and Financial Markets

	2004 £m	2003 £m	2002 £m
Net interest income excluding funding cost of rental assets	2,959	2,653	2,631
Funding cost of rental assets	(414)	(329)	(282)
Net interest income	2,545	2,324	2,349
Fees and commissions receivable	1,723	1,537	1,394
Fees and commissions payable	(277)	(220)	(157)
Dealing profits (before associated direct costs)	1,855	1,661	1,338
Income on rental assets	1,282	1,088	931
Other operating income	381	307	197
Non-interest income	4,964	4,373	3,703
Total income	7,509	6,697	6,052
Direct expenses			
□ staff costs	1,642	1,410	1,230
□ other	412	394	375
□ operating lease depreciation	610	518	461
	2,664	2,322	2,066
Contribution before provisions	4,845	4,375	3,986
Provisions	580	755	725
Contribution	4,265	3,620	3,261
	£bn	£bn	£bn
Total assets*	265.3	219.0	203.4

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Loans and advances to customers □ gross*			
□ banking book	114.9	99.3	92.1
□ trading book	10.0	5.0	3.6
Rental assets	11.2	10.1	7.0
Customer deposits*	74.9	68.6	62.2
Weighted risk assets □ banking	160.9	140.0	125.2
□ trading	16.9	12.6	11.3

*excluding repos and reverse repos

2004 compared with 2003

Contribution increased by 18%, £645 million to £4,265 million reflecting growth in all business areas.

Total income was up 12% or £812 million to £7,509 million. Strong growth in all locations was partially masked by the effect of stronger sterling on the translation of income from Europe and North American businesses. At constant exchange rates, income grew by 14% and contribution was up 20%.

Net interest income, excluding the cost of funding rental assets, increased 12% or £306 million to £2,959 million. Average loans and advances to customers of the banking business increased by 10% or £9.5 billion to £103.8 billion. The second half of 2004 saw a modest recovery in large corporate lending. Average customer deposits within the banking business increased by 8% or £5.0 billion to £66.0 billion. An improvement in margins was achieved through strong growth in our UK mid-corporate relationships.

Fees receivable rose by £186 million, 12% to £1,723 million with growth driven by lending, structured finance and capital markets activities. Fees payable, including brokerage, were up £57 million to £277 million due to the greater volumes of trading and structuring business.

Dealing profits, which is income (before associated direct costs) arising from our role in providing customers with debt and risk management products in interest rate, currency and credit asset classes, rose by 12% to £1,855 million. Growth was achieved across all our customer segments and product classes with further diversification of dealing revenues in the US to compensate for lower residential mortgage refinancing volume than in 2003. The Group's trading value-at-risk (VaR) remains modest and the average VaR was £10.8 million (2003 □ £9.4 million).

The asset rental business, comprising operating lease assets and investment properties continued to grow strongly. Rental assets increased to £11.2 billion and income after deducting funding costs and operating lease depreciation increased by 7%, £17 million to £258 million.

Other operating income also grew strongly, up £74 million or 24% to £381 million.

Direct expenses increased by 15% or £342 million to £2,664 million. Excluding operating lease depreciation, operating expenses were up 14%, £250 million. This was mainly due to the mix effect of faster growth in businesses with inherently higher cost:income ratios, such as Capital Markets and our overseas businesses, together with the investment in new revenue initiatives in the US.

The charge for provisions for bad debts and amounts written off fixed asset investments amounted to £580 million, a decrease of 23%, £175 million. The reduction reflects an improvement in corporate credit quality and the economic environment in 2004.

2003 compared with 2002

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Contribution increased by 11% or £359 million to £3,620 million. As well as in the UK, the division also achieved good growth in Europe and North America.

Total income was up 11% or £645 million to £6,697 million with strong growth across all business areas.

Average loans and advances to customers of the banking business increased by 9% or £7.5 billion to £94.3 billion. Lending margin was maintained. Average customer deposits within the banking businesses increased by 7% or £4.1 billion to £61.0 billion; however, the lower interest rate environment adversely affected deposit margins as it reduced the benefit of interest free funds. Net interest income was further impacted by the effect of implementing from 1 January 2003 the pricing remedies agreed following the Competition Commission inquiry into SME banking and by lower money market income, due to less favourable market conditions.

The asset rental business comprising operating leases and investment properties, grew strongly. Rental assets increased to £10.1 billion and net income after deducting funding costs and operating lease depreciation increased by 28%, £53 million to £241 million.

Fees receivable rose by £143 million, 10% to £1,537 million due to growth in fees related to lending and from the expansion and success of capital markets activities. Fees payable including brokerage were up £63 million to £220 million due to higher volumes in Financial Markets.

Dealing profits which is income (before associated direct costs) arising from our role in providing customers with debt and risk management products in interest rate, currency and credit asset classes, rose by 24% to £1,661 million providing incremental profit contribution of some £170 million. There was steady growth in underlying customer volumes in all product areas. While first half performance was particularly strong given the unusually high levels of demand for mortgage backed securities in the United States, dealing revenues in the second half were up 10% on the prior year period, in line with the growth in income for the division as a whole.

Other operating income was up £110 million, 56% to £307 million partially due to the full year effect of the inclusion of Dixon Motors's gross profit.

Direct expenses increased by 12% or £256 million to £2,322 million. Excluding the effect of the acquisition of Nordisk Renting and Dixon Motors and operating lease depreciation, operating expenses were up 10%, £161 million. This was due to performance related costs associated with the strong growth in trading revenues, expansion in all business areas and continued investment in capital market activities and in the growing overseas franchise.

The charge for provisions for bad debts and amounts written off fixed asset investments amounted to £755 million, an increase of £30 million. The charge in the second half of the year was £351 million, 13% lower than the first half. The increase in provisions of 4% over last year was less than the growth in lending of 9%, reflecting an improvement in credit quality and the economic environment during 2003.

Operating and financial review continued

Retail Banking

	2004 £m	2003* £m	2002* £m
Net interest income	3,112	2,959	2,849
Non-interest income	1,630	1,514	1,430

Total income	4,742	4,473	4,279
Direct expenses			
□ staff costs	834	793	729
□ other	240	237	263
	1,074	1,030	992
Contribution before provisions	3,668	3,443	3,287
Provisions	389	273	213
Contribution	3,279	3,170	3,074
	£bn	£bn	£bn
Total banking assets	74.2	63.9	57.4
Loans and advances to customers □ gross			
□ mortgages	44.1	36.6	32.1
□ small business	15.2	13.8	12.5
□ consumer lending	12.9	11.4	11.0
Customer deposits	70.6	66.5	61.9
Weighted risk assets	49.7	42.9	38.8

* prior periods have been restated to reflect the transfer in 2004 of certain activities from Wealth Management.

2004 compared with 2003

The division continued to achieve strong volume growth across all key product areas □ in particular mortgages, loans and savings □ supported by increased customer numbers. As a result, income increased by 6% or £269 million to £4,742 million, and contribution by 3% or £109 million to £3,279 million.

Net interest income rose by 5% or £153 million to £3,112 million, reflecting strong growth in lending and deposits which more than offset the impact of business mix □ particularly strong growth in low risk mortgage lending □ and the impact of lower margin in some areas, especially unsecured lending. Average loans to customers, excluding mortgages, grew by 12% or £2.8 billion to £26.5 billion. Average mortgage lending grew by 21% or £7.0 billion to £40.7 billion. Both mortgage and non-mortgage lending have evidenced a slowdown in growth in the second half of the year. Average customer deposits increased by 8% or £4.9 billion to £66.0 billion.

Non-interest income rose by 8% or £116 million to £1,630 million. This reflected higher fee income associated with strong asset growth in both personal and business sectors together with increased volumes of money transmission activity.

Direct expenses increased by 4% or £44 million to £1,074 million. Staff expenses increased 5% or £41 million to £834 million, principally due to the deployment of an additional one thousand customer facing staff in the NatWest network. The increase in other expenses was 1% or £3 million, reflecting rigorous cost management.

The charge for provisions for bad and doubtful debts increased by £116 million to £389 million. The increased charge reflects the anticipated increase in delinquency rates in the NatWest portfolio following growth in unsecured lending in recent years. NatWest credit experience is now broadly consistent with the RBS portfolio which has been stable for a number of years. As reported in the first half, there has also been a higher incidence of fraud which has led to some deterioration in recovery rates.

The overall quality of the loan portfolio, the majority of which is mortgage lending, as measured by probability of default, remained in line with expectations.

2003 compared with 2002

The division achieved strong volume growth across all personal product areas - current accounts, mortgages and loans and savings. Despite lower interest rates and the adverse effect of the pricing remedies agreed following the Competition Commission inquiry into SME banking which were implemented from 1 January 2003, income increased by 5% or £194 million to £4,473 million, and contribution by 3% or £96 million to £3,170 million.

Net interest income rose by 4% or £110 million to £2,959 million, reflecting the continued strong growth in customer advances and deposits which was partially offset by the implementation of the Competition Commission pricing remedies and the impact of a lower interest rate environment. Excluding the effect of the Competition Commission the increase was 8%. Average loans to customers, excluding mortgages, grew by 9% or £1.9 billion to £23.7 billion. Average mortgage lending grew by 12% or £3.6 billion to £33.7 billion. Average customer deposits increased by 6% or £3.7 billion to £60.9 billion.

Non-interest income rose by 6% or £84 million to £1,514 million. This reflected further growth in the customer base and a 15% growth in general insurance income to £301 million. Embedded value profits of the life assurance business increased by 14%, or £7 million to £57 million.

Direct expenses increased by 4% or £38 million to £1,030 million. Staff expenses increased 9% or £64 million to £793 million reflecting further investment in customer facing staff.

Other expenses decreased 10% or £26 million to £237 million, as a result of our rigorous approach to management of non-staff costs.

The charge for provisions for bad debts increased by £60 million to £273 million. The overall quality of the loan portfolio remained stable and the increased charge reflected growth in lending over recent years particularly in NatWest since its acquisition.

Operating and financial review continued

Retail Direct

	2004 £m	2003* £m	2002* £m
Net interest income	938	849	749
Non-interest income	1,191	986	841
Total income	2,129	1,835	1,590
Direct expenses			
□ staff costs	259	211	190

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□ other	453	446	411
	712	657	601
Contribution before provisions	1,417	1,178	989
Provisions	377	297	281
Contribution	1,040	881	708
	£bn	£bn	£bn
Total assets	26.9	21.9	19.4
Loans and advances to customers □ gross			
□ mortgages	9.2	8.2	7.0
□ other	16.0	13.8	12.4
Customer deposits	4.4	4.4	4.4
Weighted risk assets	21.1	16.8	14.4

* prior periods have been restated to reflect the transfer in 2004 of certain activities to Manufacturing.

2004 compared with 2003

Contribution increased by 18% or £159 million to £1,040 million.

Total income was up 16% or £294 million to £2,129 million, reflecting continued strong growth across all products, particularly credit cards. Excluding acquisitions income rose by 9%, £155 million, and contribution was up by 14%, £125 million. Net interest income was up 10% or £89 million to £938 million. Average lending rose by 19% to £24.2 billion, of which average mortgage lending was 16% higher at £8.8 billion, mainly in The One account. Average customer deposits were stable. The new MINT branded credit card was launched in December 2003 and while the 0% introductory interest rate for nine months on MINT cards depressed net interest margin, over 711,000 MINT credit cards have been issued and attracted significant balances. During 2004, the total number of customer accounts increased by 2.3 million.

Non-interest income was up 21% or £205 million to £1,191 million, reflecting increased volumes and acquisitions.

Direct expenses increased by 8% or £55 million to £712 million. Staff costs were up 23%, due to the acquisitions and increased headcount to support higher business volumes. Excluding acquisitions, staff costs were up 8%. The increase in other expenses was limited to 2%, as a result of tight cost management and efficiencies within the core businesses.

The charge for provisions for bad debts increased by £80 million or 27% to £377 million, reflecting the growth in lending volumes and the acquisition of the credit card business from People's Bank.

Excluding acquisitions, provisions for bad debts were up 14%, £41 million. Credit metrics across the portfolio remain broadly stable, however consistent with the market there was some increase in the levels of arrears towards the end of the year in credit cards.

2003 compared with 2002

Contribution increased by 24% or £173 million to £881 million.

Total income was up 15% or £245 million to £1,835 million, reflecting continued strong growth in supermarket banking (TPF), mortgages and cards. Net interest income was up 13% or £100 million to £849 million. Average

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lending rose by 15% to £20.3 billion of which average mortgage lending was 20% higher at £7.6 billion mainly in The One account. Average customer deposits were up 5% to £4.4 billion. During 2003, the total number of customer accounts increased by 1.7 million.

Non-interest income was up 17% or £145 million to £986 million. There was good growth in insurance and ATM income resulting from increased volumes, particularly in TPF and in the Cards Business.

Direct expenses increased by 9% or 7% excluding acquisitions, and other expenses increased by £35 million, 9% (7% excluding acquisitions), with increased processing and operational costs in support of the higher business levels.

The charge for provisions for bad debts increased by £16 million or 6% to £297 million, reflecting growth in lending volumes offset by higher recoveries. The indicators of credit quality remained stable.

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Manufacturing

	2004 £m	2003* £m	2002* £m
Staff costs	794	671	571
Other costs	1,645	1,443	1,381
Total manufacturing costs	2,439	2,114	1,952
Analysis:			
Group Technology	807	686	665
Group Purchasing and Property Operations	854	718	649
Customer Support and other operations	778	710	638
Total manufacturing costs	2,439	2,114	1,952

* prior periods have been restated to reflect the transfer in 2004 of certain activities, principally from RBS Insurance and Ulster Bank.

2004 compared with 2003

Manufacturing's costs increased by £325 million, 15% to £2,439 million.

Manufacturing is now supporting RBS Insurance and Ulster Bank and of the £325 million increase, £82 million reflects technology and property operations of Churchill (2004 □ £96 million; 2003 □ £33 million) and First Active (2004 □ £19 million; 2003 □ £nil) which were acquired in September 2003 and January 2004 respectively.

The balance of the increase was required to support higher business volumes, to upgrade the Group's regional property portfolio and to invest in the Group Efficiency Programme initiatives that are improving the Group's overall efficiency.

A number of initiatives aimed at improving efficiency and customer service were introduced in the year, including a sales prompt system on screens in NatWest branches and in RBS and NatWest telephony: enhanced fraud prevention; conversion of paper based branch reports to screen; image and workflow capability in service centres; the introduction of a new image enabled mortgage platform which has improved the efficiency and quality of our service and the introduction of an on-line customer query management system.

2003 compared with 2002

Manufacturing costs increased by 8% or £162 million, to £2,114 million.

Group Technology costs increased by £21 million to £686 million. This reflected business as usual cost growth and a specific improvement programme, the majority of the cost of which will be borne by Group Technology. This is providing benefits across the Group and further investment opportunities were identified which will lead to further efficiency benefits across the Group.

The cost base of Group Purchasing and Property Operations rose by 11% or £69 million to £718 million, largely as a result of the continuing upgrade of the property portfolio in major UK centres to support the Group's core business.

Customer Support and other operations costs were £710 million, 11% or £72 million higher than the previous year. This reflected further expansion of business operations with increased expenditure in customer support areas of Lending, Telephony, Payments and Security. In telephony, the Royal Bank of Scotland customer service proposition was introduced to NatWest customers who can now choose between speaking to their local branch, to a customer service officer or using the automated telephone service.

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Operating and financial review continued

Wealth Management

	2004 £m	2003* £m	2002* £m
Net interest income	497	457	451
Non-interest income	451	352	370
Total income	948	809	821
Expenses			
□ staff costs	299	259	279
□ other	164	139	146
	463	398	425
Contribution before provisions	485	411	396
Provisions for bad and doubtful debts □ charge/(release)	17	9	(11)
Contribution	468	402	407
	£bn	£bn	£bn
Loans to customers	9.2	7.9	7.3
Investment management assets □ excluding deposits	22.3	22.3	16.1
Customer deposits	31.7	29.1	28.9
Weighted risk assets	8.3	9.1	8.4

* prior periods have been restated to reflect the transfer of certain activities to Retail Banking and Manufacturing.

2004 compared with 2003

Contribution at £468 million was £66 million or 16% higher than 2003. Excluding the acquisition and adjusting for the disposal, contribution was up 14%, £54 million.

Total income increased by 17% or £139 million to £948 million, including a full year contribution from Bank von Ernst. Excluding the acquisition and disposal, income was 12%, £94 million higher.

Net interest income increased by 9% or £40 million to £497 million. The increase reflects growth in both lending and deposit volumes, combined with the benefit of higher average interest rates.

Non-interest income increased by 28% or £99 million to £451 million, reflecting higher fee income as a result of the improved equity markets and the acquisition of Bank von Ernst.

Investment management assets were stable at £22.3 billion. Excluding the acquisition and disposal and at constant exchange rates, investment assets increased 7%.

Expenses were up by 16% or £65 million to £463 million to support the growth in income and reflecting the acquisition of Bank von Ernst. Excluding the acquisition and disposal, expenses were up 9%, £33 million.

The charge for provisions for bad and doubtful debts was £17 million compared with £9 million in 2003, reflecting a small number of specific cases.

2003 compared with 2002

Contribution was £402 million, £5 million or 1% lower than 2002. Excluding the acquisition and disposals, income was up 1%, with contribution before provisions up 4%. The charge for provisions for bad and doubtful debts was £9 million compared with a net release of £11 million in 2002.

Total income was down by 1% or £12 million to £809 million.

Net interest income increased by 1% or £6 million to £457 million. The benefit from growth in lending volumes was partly negated by the effect of lower interest rates which also caused a tightening of deposit margins.

Non-interest income declined by 5% or £18 million to £352 million. Excluding the acquisition and disposals the decrease was 1%. This reflected the impact of lower equity markets adversely affecting fees and commissions.

Investment management assets increased by £6.2 billion or 39% to £22.3 billion principally due to the acquisition of Bank von Ernst in the year.

Expenses were down by 6% or £27 million to £398 million reflecting tight cost control in difficult market conditions and the 7% reduction in staff numbers since 31 December 2002.

Provisions for bad and doubtful debts were £9 million compared with a net release of £11 million in 2002.

RBS Insurance

2004 £m	2003* £m	2002* £m
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Earned premiums	5,357	3,627	2,442
Reinsurers' share	(413)	(504)	(489)
Insurance premium income	4,944	3,123	1,953
Net fees and commissions	(488)	(161)	6
Other income	478	283	180
Total income	4,934	3,245	2,139
Expenses			
staff costs	293	222	166
other	299	219	167
	592	441	333
Gross claims	3,724	2,644	1,693
Reinsurers' share	(244)	(449)	(343)
Net claims	3,480	2,195	1,350
Contribution	862	609	456
In-force policies (000's)			
Motor: UK	8,338	8,086	4,668
Motor: Continental Europe	1,639	1,425	1,165
Other (including home, rescue, pet): UK	10,919	10,518	6,697
Gross insurance reserves total (£m)	7,394	6,582	3,002

* prior periods have been restated to reflect the transfer in 2004 of certain activities to Manufacturing and to recognise a reclassification of income from net fees and commissions to insurance premium income.

2004 compared with 2003

Contribution increased by 42% or £253 million to £862 million and included the first full year's contribution from Churchill, which was acquired in September 2003. Excluding Churchill, contribution grew by 13%, £73 million.

Total income was up 52% or £1,689 million to £4,934 million. Excluding Churchill, total income grew by 17%, £450 million.

After reinsurance, insurance premium income was up 58% or £1,821 million to £4,944 million. Excluding Churchill, net insurance premium income grew by 17%. At 31 December 2004, the number of UK in-force motor insurance policies was 8.3 million and the number of in-force motor policies in Continental Europe was 1.6 million. The International Division passed the milestone of 1 million motor policies in Spain in December. Non-motor policies, including home, rescue and pet insurance, increased to 10.9 million at 31 December 2004.

Net fees and commissions payable increased from £161 million to £488 million, due mainly to commissions payable to intermediaries in the broker division acquired as part of Churchill. Other income was up due to the acquisition of Churchill and increased investment income driven by higher business volumes.

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Expenses increased by 34% or £151 million to £592 million. Excluding Churchill, expenses increased by 10%, £37 million, to support higher business volumes.

Net claims, after reinsurance, increased by 59% or £1,285 million to £3,480 million. Excluding Churchill, net claims increased by 20%, consistent with mix and volume growth.

The UK combined operating ratio, which includes manufacturing costs, was 93.7% compared with 91.2% for 2003. This deterioration is attributable in part to a change in business mix due to the full year impact of commissions payable to brokers and intermediaries in Churchill. Excluding Churchill, the UK ratio was broadly in line with the prior year (2004 □ 89.9%; 2003 □ 88.6%).

2003 compared with 2002

Contribution increased by 34% or £153 million to £609 million. Excluding Churchill, contribution increased by 22% or £99 million.

Total income was up 52% or £1,106 million to £3,245 million. Excluding Churchill, total income grew by 25% or £525 million.

After reinsurance, insurance premium income was up 60% or £1,170 million to £3,123 million. Excluding Churchill, insurance premium income (net of reinsurance) grew by 25% or £490 million. The number of UK in-force motor insurance policies increased by 3.4 million of which 3.1 million was from Churchill, while the number of UK in-force home insurance policies increased by 3.6 million including 3.4 million from Churchill. The number of motor policies in Continental Europe increased by 260,000 during the year.

Other income net of commissions payable was down from £186 million to £122 million. Excluding Churchill, which included £148 million commissions payable to brokers and intermediaries, other income was up 19% or £35 million due to higher investment income, embedded value profits and share of associates profits.

Expenses increased by 32% or £108 million to £441 million. Excluding Churchill, expenses increased by 10% or £33 million. Staff numbers, excluding Churchill, increased by 4% (400) to support growth in business volumes, particularly in the partnership business.

Net claims, after reinsurance, increased by 63% or £845 million to £2,195 million. Excluding Churchill, net claims increased by 29% or £393 million.

UK combined operating ratio was 91.2%. Excluding Churchill, the UK ratio was 88.6% compared with 88.2% for 2002.

Operating and financial review continued

Ulster Bank

	2004 £m	2003* £m	2002* £m
Net interest income	550	396	339
Non-interest income	193	185	181

Total income	743	581	520
<hr/>			
Expenses			
□ staff costs	158	137	122
□ other	77	58	58
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	235	195	180
<hr/>			
Contribution before provisions	508	386	340
Provisions	40	32	22
<hr/>			
Contribution	468	354	318
<hr/>			
	£bn	£bn	£bn
<hr/>			
Total assets	27.4	15.6	12.7
Loans and advances to customers □ gross			
□ mortgages	8.8	2.8	1.8
□ other	12.9	8.8	7.3
Customer deposits	13.5	9.7	8.8
Weighted risk assets	18.5	11.0	9.0
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Average exchange rate $\text{€}/\text{£}$	1.474	1.445	1.591
Spot exchange rate $\text{€}/\text{£}$	1.418	1.416	1.536
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* prior periods have been restated to reflect the transfer in 2004 of certain activities to Manufacturing.

2004 compared with 2003

Contribution increased by 32% or £114 million to £468 million.

Total income increased by 28% or £162 million to £743 million reflecting the acquisition of First Active and strong organic growth, particularly in residential mortgages. Adjusting for First Active and the disposal in October 2003 of NCB Stockbrokers ('NCB'), income increased by 12% at constant exchange rates. During 2004, the number of customers increased by 454,000, of which 374,000 relate to First Active.

Net interest income rose by 39% or £154 million to £550 million, reflecting strong growth across all customer lending products and in customer deposits. Excluding First Active and NCB and at constant exchange rates, net interest income increased by 14%. The net interest margin decreased mainly due to strong growth in low risk mortgage lending both organic and due to the acquisition of First Active, a leading mortgage provider in the Republic of Ireland. Underlying product margins remain stable.

Non-interest income increased by £8 million, 4% to £193 million. Strong growth in lending fees and sales of treasury products was partially offset by a reduction in brokerage fees following the disposal of NCB. Excluding First Active and NCB, non-interest income was up 6%, £10 million.

Expenses increased by 21% or £40 million to £235 million. Excluding First Active and NCB expenses increased by 8% to support the growth in business.

The charge for provisions for bad debts increased by £8 million to £40 million, reflecting the growth in lending business. Excluding First Active and NCB provisions for bad and doubtful debts were up £4 million. Asset quality remains strong.

2003 compared with 2002

Contribution increased by 11% or £36 million to £354 million driven by strong volume growth in both loan and deposit products. The number of customers increased in 2003 by 36,000.

Total income increased by 12% or £61 million to £581 million reflecting the strong volume growth, in particular residential mortgages.

Net interest income rose by 17% or £57 million to £396 million, reflecting strong growth in both average customer lending and deposits which increased by 26% or £2.1 billion, to £10.1 billion and by 13% or £1.0 billion, to £8.9 billion respectively.

Non-interest income increased by £4 million to £185 million. Strong growth in lending, transmission and card fee income was partially offset by lower dealing profits. Uncertainty in equity markets adversely affected brokerage fees in the stockbroking business which was sold in October 2003.

Expenses increased by 8% or £15 million to £195 million. This reflected the annual pay award and the additional costs to support increased business volumes.

The charge for provisions for bad debts was up £10 million to £32 million reflecting growth in lending.

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Citizens

	2004 £m	2003 £m	2002 £m
Net interest income	1,540	1,310	1,248
Non-interest income	601	514	468
Total income	2,141	1,824	1,716
Expenses			
□ staff costs	551	505	485
□ other	473	374	370
	1,024	879	855
Contribution before provisions	1,117	945	861
Provisions	80	88	95
Contribution	1,037	857	766
	\$bn	\$bn	\$bn
Total assets	132.1	76.8	61.1
Loans and advances to customers □ gross	83.4	43.5	31.4

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Customer deposits	99.2	62.8	51.1
Weighted risk assets	87.4	50.8	38.8
Average exchange rate □ \$/£	1.832	1.635	1.503
Spot exchange rate □ \$/£	1.935	1.786	1.613

2004 compared with 2003

Contribution was affected by the weak US dollar relative to sterling and at £1,037 million was up 21%, £180 million. In US dollar terms, contribution increased by 36% or \$499 million to \$1,900 million. Excluding the acquisitions, contribution increased by 13% or \$183 million to \$1,570 million.

Total income was up 31% or \$939 million to \$3,923 million. During 2004, Citizens increased its personal customer base by 1,993,000 accounts and its business customers by 174,000. Excluding the acquisitions, Citizens increased its personal customers by 199,000 and its business customers by 30,000.

Net interest income increased by 32% or \$678 million to \$2,821 million, reflecting the acquisitions and strong organic growth in both personal loans and deposits. Excluding the acquisitions, net interest income increased by 11% or \$228 million, average loans were up 24% or \$8.8 billion and average deposits were up 14% or \$8.0 billion. The benefit from higher volumes more than offset the impact of interest rates on margins.

Non-interest income rose by 31% or \$261 million to \$1,102 million. Excluding the acquisitions, non-interest income increased 6% or \$47 million before a reduction in mortgage fees, down from \$53 million to \$24 million in 2004.

Expenses increased by 31% or \$439 million to \$1,877 million. Excluding acquisitions, expenses were up 7% due to additional costs to support higher business volumes, investment in branch automation and the expansion of traditional and supermarket banking in Mid Atlantic and New England.

Provisions increased by only \$1 million to \$146 million, with credit quality metrics remaining strong.

2003 compared with 2002

Contribution which increased by 12% or £91 million to £857 million was diminished by the weakening of the US dollar in relation to sterling. In US dollar terms, contribution increased by 22% or \$250 million to \$1,401 million.

Total income was up 16% or \$406 million to \$2,984 million.

Net interest income increased by 14% or \$268 million to \$2,143 million. Excluding the acquisitions, net interest income was up 9% or \$164 million (£100 million), reflecting strong organic growth in personal loans and deposits. Excluding the acquisitions, average loans were up 29% or \$8.0 billion and average deposits were up 20% or \$9.1 billion. The benefit of this growth was reduced by a narrowing interest margin due to reductions in US interest rates.

Non-interest income rose by 20% or \$138 million to \$841 million. Excluding the acquisitions, non-interest income was up 16% or \$115 million (£70 million).

Expenses increased by 12% or \$153 million to \$1,438 million. Excluding the acquisitions, expenses increased by 8% or \$102 million (£62 million), to support higher business volumes and expansion of Citizens' supermarket banking programme.

Provisions were up \$3 million from \$142 million to \$145 million. Excluding the acquisitions, provisions were \$2 million (£1 million), or 1%, lower than 2002. Credit quality metrics remained strong and total non-performing loans were 0.40% of total loans and advances at 31 December 2003 compared with 0.57% at the end of 2002.

In 2003, Citizens increased its personal customer base by 376,000 accounts and its business customers by 36,000 due to growth through both traditional and supermarket branches, and the acquisition of Commonwealth Bancorp, Inc., Port Financial Corp. and Community Bancorp, Inc.

Operating and financial review continued

Central items

	2004 £m	2003* £m	2002* £m
Funding costs	284	215	215
Departmental and corporate costs	595	496	283
Total Central items	879	711	498

* prior periods have been restated following the implementation of FRS 17.

2004 compared with 2003

Total Central items increased by £168 million to £879 million.

Funding costs at £284 million, were up 32% or £69 million reflecting the funding of the various acquisitions undertaken by the Group during the year.

Changes in net pension costs on the adoption of FRS 17 are reported in Central items. These comprise higher pension cost of £81 million partially offset by the expected return on pension scheme assets less interest on scheme liabilities of £33 million.

Central departmental costs and other corporate items at £595 million were £99 million or 20% higher than 2003. This is principally due to higher Group pension costs, up £48 million, the centralisation of certain functions and expenditure on Group-wide projects such as International Accounting Standards and Basel II.

2003 compared with 2002

Total Central items increased by £213 million to £711 million.

Funding costs were £215 million. Increased income from higher shareholders' funds was offset by the funding costs associated with the acquisition of Churchill in September 2003 and the £1.5 billion AVS dividend paid in December 2003.

Central departmental costs and other corporate items at £496 million were £213 million or 75% higher than 2002. Net pension costs increased by £172 million reflecting lower returns on pension scheme assets together with increased pension costs. This was also partly due to staff costs and other costs relating to certain departments such as Customer Relations which have been centralised and additional resources devoted to Group wide projects such as preparations for the implementation of Basel II and International Accounting Standards.

Employee numbers at 31 December

	2004	2003	2002
Corporate Banking and Financial Markets	16,400	15,900	16,900
Retail Banking*	32,200	31,100	30,500
Retail Direct	9,700	7,300	7,000
Manufacturing*	24,900	23,400	23,200
Wealth Management*	5,200	5,200	5,600
RBS Insurance*	19,500	18,800	10,300
Ulster Bank*	4,100	3,400	3,300
Citizens	22,600	14,100	13,300
Centre	2,000	1,700	1,700
Group total	136,600	120,900	111,800
Acquisitions in the year	10,500	9,700	5,600
Underlying	126,100	111,200	106,200

*prior periods have been restated to reflect the transfer in 2004 of certain activities from Wealth Management to Retail Banking and from F

2004 compared with 2003

The number of employees increased by 15,700, 13% to 136,600. The acquisitions in the year added 10,500 staff, including over 8,100 relating to Charter One.

2003 compared with 2002

The number of employees increased by 9,100, 8% to 120,900. The acquisition of Churchill added 8,500 staff in RBS Insurance.

Operating and financial review continued**Consolidated balance sheet
at 31 December 2004**

	2004 £m	2003* £m
Assets		
Cash and balances at central banks	4,293	3,822
Items in the course of collection from other banks	2,629	2,501
Treasury bills and other eligible bills	6,110	4,846
Loans and advances to banks	58,260	51,891
Loans and advances to customers	345,469	252,531
Debt securities	91,211	79,949
Equity shares	2,960	2,300

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Intangible fixed assets	17,576	13,131
Tangible fixed assets	16,294	13,927
Settlement balances	5,682	2,857
Other assets	22,255	17,807
Prepayments and accrued income	6,928	5,309
	<hr/>	
	579,667	450,871
Long-term assurance assets attributable to policyholders	3,800	3,557
	<hr/>	
Total assets	583,467	454,428
	<hr/>	
Liabilities		
Deposits by banks	99,081	67,323
Items in the course of transmission to other banks	802	958
Customer accounts	285,062	236,963
Debt securities in issue	58,960	41,016
Settlement balances and short positions	32,990	21,369
Other liabilities	26,152	20,584
Accruals and deferred income	15,588	13,155
Post-retirement benefit liabilities	1,901	1,445
Provisions for liabilities and charges	3,071	2,249
Subordinated liabilities	20,366	16,998
Minority interests		
□ equity	158	(11)