



Interim Report

for the period 1 July 2010 to 31 December 2010

February 2011

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Commentary

There have been a number of key developments in the period since the APA's 2009/10 Annual Report and Accounts published on 22 July 2010 that are worthy of comment in this interim report, which covers the six month period to 31 December 2010. It is our intention to publish interim reports in addition to our Annual Report and Accounts in future years also.

Operation of the APA

The APA has now moved from a project focused operating model to an increasingly programme orientated, "every-day" working model. This has led to a reduction in the operating and execution risks for the taxpayer associated with setting up an executive public sector agency on short notice to operate and oversee an unprecedented distressed asset insurance scheme. Staff turnover and the use of interim resources from consultants have receded, while IT systems and risk models have been developed and rolled out successfully.

The Scheme has now been operational for just over 12 months and working relationships between RBS and the APA have bedded down considerably on a strategic and day-to-day level as individuals on each side have adapted to new working practices and requirements.

During the period our senior team has been quite stable. Lucy Wylde, an experienced Slaughter and May partner, who has been seconded to us since the start of our operations, will be formally joining as our full time General Counsel on 1 May 2011 after winning an open competition for the post. Apart from the resignation of Cynthia Parker in October, there are no further senior management changes to report for the period.

Our operating costs (which are fully recharged to RBS) are running significantly below budget for the year due to a significantly lower spend on third party advisers and consultants. This did not result in the APA having significantly less benefit from third party advice and expertise than we intended when we planned for the year. Rather the bulk of the underspend is due to our deliberate policy of ensuring where possible that any requisite third party expertise is hired directly by RBS. We are pleased that RBS management have supported this approach, which allows them to benefit from knowledge transfer from the third party expertise as well.

Operation of the APS

During the period to 31 December 2010, the financial risk to HMT as an insurer of the APS assets receded. The expected outcome for HMT as an insurer remains an overall £5bn profit from the Scheme, to which we are now a little closer, having received cash payments of £2.5bn from Lloyds and £2.1bn from RBS. The likelihood of RBS being able to make a claim under the Scheme has receded with the expected loss outcome now at £51bn, down from £57bn as reported in our Annual Report and Accounts 2009-10. The comfort level with regard to the £60bn first loss threshold (and the £73bn second loss threshold – through NPVs of future fees as shown in the Chief Risk Officer's review in Annex A of this report) has therefore increased. We no longer expect HMT to have to make any temporary cash payouts under the Scheme which would have been reversed later as recoveries come in.

The main drivers of reduced risk in the APS are twofold. First, in an environment where expected loss remains below £60bn, we benefit from the passing of time in a static portfolio; loans redeem or extend and therefore lose insurance cover; defaulted loans begin to show recoveries, as for instance company stakes resulting from previous debt for equity swaps can be sold off in buoyant equity markets. These developments provide certainty of outcome for both defaulted and non-defaulted loans, which reduces the volume of exposure in the APS where the outcome is still uncertain. Secondly, the global economy has continued its fragile recovery, which has been reflected in a bottoming out of prices and values in most markets, and strong continuing recoveries in the equity and corporate bond markets. While some markets such as Spain and Ireland continued to deteriorate, the macro-environment was favourable or neutral for the vast majority of our underlying exposures.

While RBS as a bank has also benefited from the economic environment as far as it pertains to the APS portfolio, two points are worth noting. First, (outside the rollover regime for certain sterling assets) where RBS extends the maturity of a loan to a borrower, the APS cover generally falls away at the time of the original maturity. Secondly, the APS was designed to guard for the risks as perceived by RBS and HMT in early 2009, when assets were selected. Its parameters therefore excluded some asset groups such as all sovereign exposures where risk has materially increased since the APS was established.

The APS continues to provide cover to RBS for the main 2009 risk factors of real estate, structured finance, as well as corporate and consumer default in a double dip. We expect these risks to subside over time.

Accounting treatment of the APS

For the purposes of the financial accounts of HMT and RBS the APS is accounted for as a credit derivative, with mark-to-market movements in each accounting period. Credit market volatility and internal modelling changes have led to some significant movements in RBS' reported quarterly earning statements, which are explained in more detail in the Chief Financial and Operating Officer's section of this report.

We have continued to recognise that improvements in how many Covered Assets are managed, controlled, documented and processed could not be achieved overnight. Because of this, the APA has been very considered in exercising its formal powers over RBS and has instead fashioned multi-layered dialogue with RBS which seeks to address issues together.

Annex A: Business Review

A.1 Chief Investment Officer's review

A.1.1 Oversight and Monitoring

The Investment Management team fulfils its responsibility for oversight and monitoring of Covered Assets by:

- reviewing files (i) presented to the APA and requiring a credit decision (credit reviews) and (ii) selected by the APA for review (asset reviews). Credit reviews are a priority for the APA as it is required to respond in a timely manner to requests by RBS for credit decisions (within five Business Days unless further information is required but often more quickly); and
- reviewing RBS business divisions which manage significant numbers of Covered Assets, including assessing their strategies, operations and management capabilities.

As at 31 December 2010, the Investment Management team comprised 15 asset specialists supported by two Chief Credit Officers who advise the Investment Management team. The asset specialisations reflect the larger asset classes in the Scheme by APA workstream: commercial real estate finance, corporate and leveraged finance, and structured finance.

Credit and asset reviews

The team's objective for the 2010/11 financial year is to complete reviews of all large (>£50m) Covered Assets, 573 borrower groups files representing £91.6bn Covered Amount as at 31 December 2010, designated as the team's "focus portfolio".

At 31 December 2010:

- the team had categorised all 573 borrower groups in the focus portfolio into Red, Amber and Green categories according to exposure size, risk, and restructuring activity (Red being the most prioritised file for review);
- as can be seen from Figure 1 below, the team had completed detailed asset reviews on more than 76 per cent by value of the Red and Amber files. The team aims to have reviewed before the APA year end all Red and Amber files and be confident that Green files are low risk;
- asset reviews had been completed on 319 files in total representing £62.2bn of Covered Amount. This represented 56 per cent by number and 68 per cent by value of the target accounts for review;
- a further 112 cases/£17.3bn by volume were under review which, combined with the completed asset review files, represented 76 per cent of the total borrower group files by number and 87 per cent by value; and
- 324 credit reviews requested by RBS had been resolved (cumulative Covered Amount £50.1bn).

Figure 1 below illustrates the Investment Management team's focus portfolio "Red, Amber, Green" categorisation by number of cases and value as at 31 December 2010. It also identifies the numbers of files for each category on which asset reviews had been completed or were under review as at 31 December 2010.

Figure 1: Asset reviews of files by number and value (£m) in Investment Management team's focus review portfolio

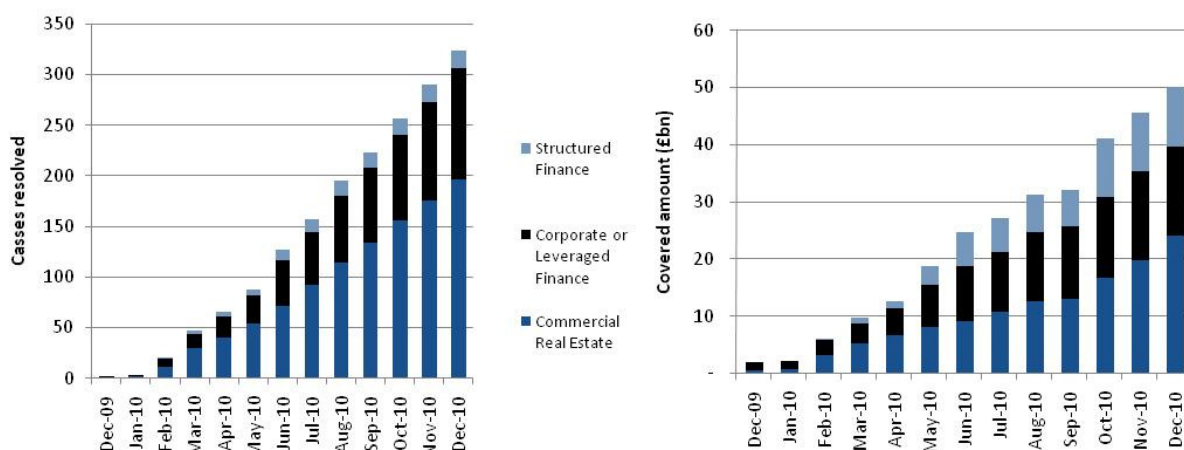
By number	Total		Asset Reviews Completed		Under Review		Remainder	
	#cases	%cases	#cases	%cases	#cases	%cases	#cases	%cases
Red	84	15	64	76	18	21	2	2
Amber	171	30	102	60	33	19	36	21
Green	318	55	153	48	61	19	104	33
Total	573	100%	319	56%	112	20%	142	25%

By value (£m)	Total		Asset Reviews Completed		Under Review		Remainder	
	£m	%	£m	%	£m	%	£m	%
Red	20,840	23%	16,418	79%	4,250	20%	171	1%
Amber	27,579	30%	20,810	75%	4,305	16%	2,465	9%
Green	43,134	47%	25,002	58%	8,735	20%	9,398	22%
Total	97,553	100%	62,230	68%	17,290	19%	12,033	13%

Source: APA

Figure 2 below shows the cumulative completed credit reviews by APA workstream by volume and value as at 31 December 2010. The majority of credit reviews related to commercial real estate finance. Since March 2010 the volume of credit reviews have been stable at between 5 and 10 per week.

Figure 2: Cumulative completed credit reviews by APA asset class by volume and value (£bn)



Source: APA

Note: The asset classes used in Figure 2 reflect the asset classes defined by the APA for management purposes and not the Covered Asset Classes defined in the APS.

Business reviews

The APA reviewed all RBS business divisions which manage significant amounts of APS Covered Assets. In addition, a number of in-depth business reviews are under way or have been completed by external consultants and/or by APA staff. These reviews cover the global restructuring group, structured finance, commercial real estate finance, unsecured consumer loans, residential mortgages and shipping finance. The purpose of these reviews has been to ensure that the Covered Assets receive the best possible asset management, including outsourced asset management if appropriate. In some cases these reviews resulted in recommendations being made for changes in strategy, operations, reporting, controls or risk management and the APA is working with RBS to implement these changes.

A.1.2. RBS performance and compliance

Credit memos and financial analysis

We previously reported our concern over the quality of credit memos and financial analysis received from RBS and the consistency with which RBS manages the Covered Assets in accordance with the AMO. Parts of RBS Core Bank have instituted important changes to the credit responsibilities and processes which we hope in time will lead to better quality credit analysis in this area; and the global restructuring group has initiated an external review of its credit memos, which when implemented should help to improve the financial analysis in this area. Work continues to bring other business areas of RBS in line with these business areas.

Negotiations on Scheme Documents

At the Accession Date, RBS and HMT agreed to negotiate in good faith to resolve certain interpretation and application issues that were not able to be resolved fully before then due to the complexity and scale of the Scheme. As at 31 December 2010, RBS and the APA had agreed in principle on virtually all priority issues and were working on documenting the necessary changes to the Conditions or the reporting requirements.

Covered Asset restatement

Earlier in the year RBS and HMT had a difference of opinion as to the status of certain structured credit assets for the purposes of the Scheme. During the period RBS paid HMT a £2.8m additional fee in order to extend the time available for discussion between the parties and the determination of the treatment of the relevant assets for the purposes of the Scheme was resolved.

Compliance

The Conditions of the Scheme include the requirement for RBS to establish a Senior Oversight Committee (SOC). The SOC is charged with developing a strategy for, and providing oversight and supervision of, compliance with the Scheme and reviewing the business strategies and governance arrangements of RBS in connection with the Scheme. During the period the SOC appointed a number of Special Advisers to assess and make recommendations in relation to four distinct areas of RBS business:

- governance and strategy of all RBS assets in the Scheme;
- management and strategy for commercial real estate assets in the Scheme;
- close monitoring of one individual corporate equity asset; and
- close monitoring of one individual large commercial real estate asset.

Apart from one report which is still pending, the three other SOC Special Advisers substantially completed their work and provided reports and recommendations to the APA and RBS. In our view, these SOC Special Adviser reports were of high quality and their recommendations are consonant with the APA's view of the desirable overall strategy for Covered Assets.

We are now seeking to ensure that RBS begins to implement their recommendations.

A.2 Chief Risk Officer's review

The APA has a range of risk policies and supporting processes in place to identify and manage its risks and to promote a strong culture of risk awareness throughout its operations. The risks associated with running the Scheme fall into two broad categories:

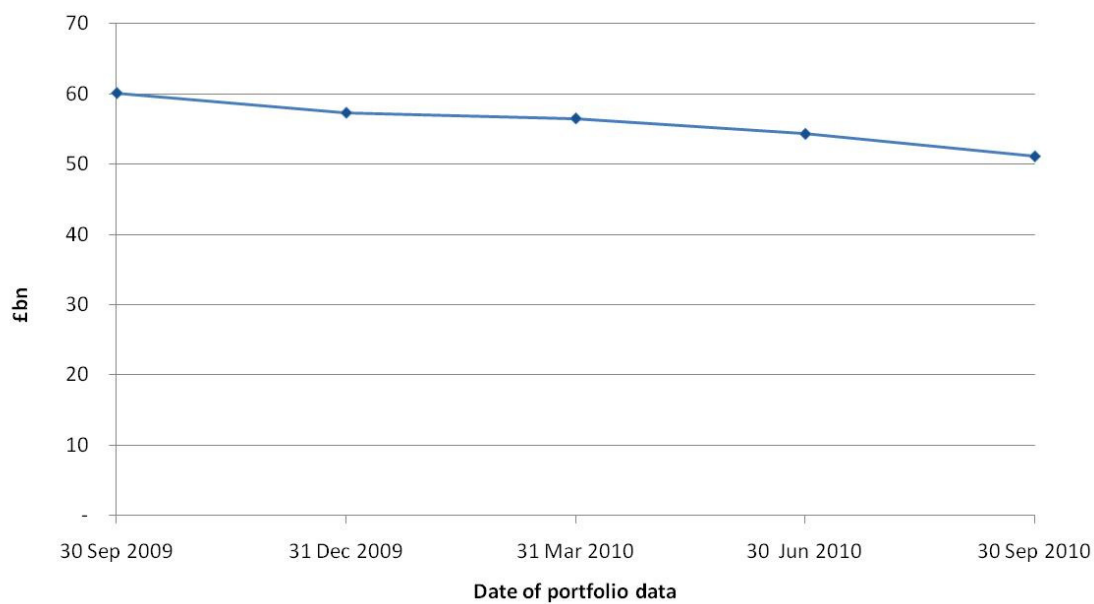
- financial risks associated with HMT's potential liability under the Scheme; and
- operational risks of running the Scheme and the APA.

During the period a number of important milestones have been reached in the Risk area including staffing up the team to a total headcount of 13 and meeting the relevant objectives and targets defined in the APA's 2010/11 Business Plan. In particular, the Risk team has produced quarterly loss forecasts and fair valuations of the Scheme for monitoring and reporting purposes. Moreover, the Risk team has been awarding Loss Credits where RBS has disposed of Non-Triggered Assets to ensure that the effectiveness of the Scheme cover is maintained and that RBS continues to be incentivised to de-risk the Scheme portfolio.

A.2.1. Developments in the APS risk exposure

At 30 September 2010, Triggered Amount (including Loss Credits) stood at £42bn and Recoveries at £5bn, meaning 62 per cent of the first loss threshold of £60bn had been utilised. The APA base case Expected Loss forecast based on 30 September 2010 portfolio data was £51bn, down from an Expected Loss forecast of £57bn based on 31 December 2009 portfolio data (as presented in the APA's 2009/10 Annual Report and Accounts). The APA's forecast of Expected Loss has followed a downward trend since the initial forecast was prepared on 30 September 2009 portfolio data as illustrated in Figure 3 below. The downward trend reflects improvements in the economic environment and risk parameters as well as the APA's deeper understanding of the Covered Assets, which has enabled it to unwind some of the conservatism built into earlier forecasts.

Figure 3: Evolution of Expected Loss



Source: APA analysis.

Although, the Expected Loss forecasts have been declining, it is important to stress that significant downside risk remains in the APS portfolio. To better understand the extent of this downside risk, the APA has prepared a stress case loss forecast based on 30 September 2010 portfolio data and the macroeconomic stress test scenario set out in the FSA's Financial Risk Outlook 2010 with some adaptation to fit APA models.

In summary, this stress test scenario applies a severe stress to the macroeconomic environment from the middle of 2010. The scenario assumes a further decline in GDP of 2.5 per cent from Q3 2010 to a trough in Q1 2012 with gradual recovery thereafter. Alongside this fall in GDP, the scenario includes a rise in unemployment to a peak of 13.3 per cent in 2013, and allows for a 'double-dip' in property prices, with house prices falling by 24 per cent from current levels and commercial property by more than 37 per cent. The APA has used similar magnitude stress assumptions for the economic development outside the UK.

On aggregate, the APA predicts an Expected Loss on the APS portfolio of £63bn under the macroeconomic stress test scenario, which is 24 per cent higher than in the base case scenario. Table 1 below shows the Covered Amount, Triggered Amount and Expected Loss across asset classes for the APA's base and stress case forecasts based on portfolio data as at 30 September 2010. In the APA's base case, the overall Expected Loss on the portfolio is estimated at 18 per cent with consumer finance, leveraged finance, commercial real estate finance and structured finance portfolios representing almost 75 per cent of total Expected Loss in the base case. The APA stress case loss forecast is particularly driven by increased losses in commercial real estate, structured finance and derivatives.

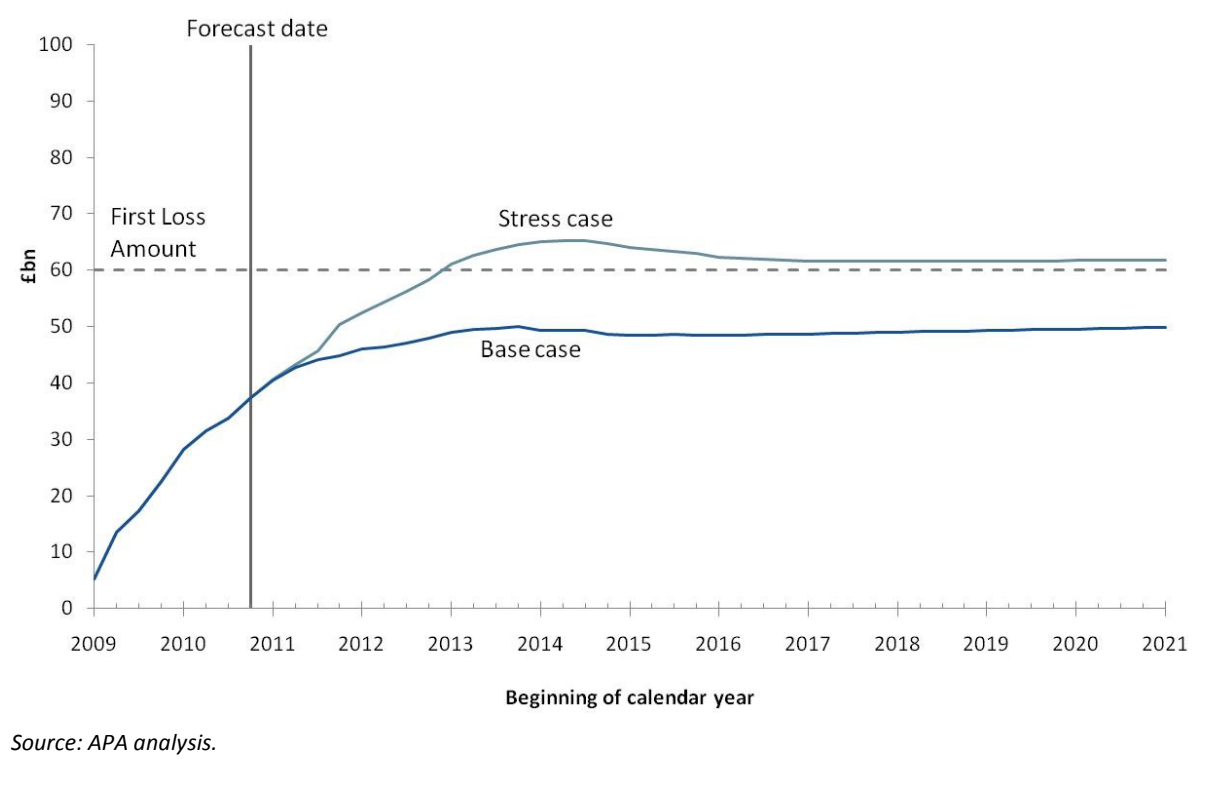
Table 1: Base and stress case loss forecasts based on portfolio data at 30 September 2010 (£bn unless otherwise stated)

APS Asset Classes	Initial Covered Amount at 31/12/2008	Covered Amount at 30/09/2010	Triggered Amount including Loss Credits net of Recoveries	Base case		Stress case	
				Expected Loss	% of initial Covered Amount	Expected Loss	% of initial Covered Amount
Residential mortgages	15	14	1	2	14%	3	17%
Consumer finance	55	50	9	11	21%	13	24%
Bonds	2	1	0.0	0.1	7%	0.2	10%
Loan	80	46	5	7	8%	8	10%
Lease finance	2	1	0.4	0.5	19%	0.5	20%
Project finance	2	2	0.0	0.2	10%	0.3	12%
Leveraged finance	28	19	5	5	19%	6	21%
Commercial real estate	40	30	7	7	18%	11	28%
Structured finance	36	25	9	14	38%	16	43%
Derivatives	26	19	1	4	15%	6	23%
Total	286	205	37	51	18%	63	22%

Source: APA

Figure 4 below shows the projections of Net Loss (i.e. Triggered Amount minus Recoveries at any given point in time) for the base and stress cases based on portfolio data as at 30 September 2010. Under the base case, Net Loss is not expected to exceed the £60bn first loss amount; however, for the stress case this would be expected to happen in the fourth quarter of 2012.

Figure 4: Base and stress case Net Loss forecasts based on portfolio data as at 30 September 2010



It is important to emphasise that loss forecasting both under the base and stress case scenarios continues to be associated with significant uncertainty. This is partly due to the uncertainty of how many of the currently Non-Triggered Assets will eventually trigger, and partly due to uncertainty of Recoveries on already and future Triggered Assets.

The breakdown of base case Expected Loss by already triggered and yet to trigger assets based on portfolio data as at 30 September 2010 is shown in Table 2 below. As can be seen, of the £205bn of cover that remains outstanding for an approximate weighted average life of 4 years, the APA is predicting that a further £37bn of assets will eventually trigger resulting in a contribution to Expected Loss of £22bn. Of the £42bn of already Triggered Assets only 36 per cent of expected Recoveries of £13bn have so far been realised. Expected Loss on Triggered Assets is predicted to be 68 per cent on average, which reflects assessments of the Loss Given Default of individual assets adjusted where appropriate for the longer grace period of the APS Trigger definition compared to Basel II/BIPRU definition of default. The recovery rate on already Triggered Assets is forecast to be slightly worse than on future Triggers, reflecting the adverse selection of the portfolio and the fact that Triggers so far have generally been in relation to poorer quality assets.

Table 2: Triggered Amount, Recoveries and EL by already and yet to trigger assets (£bn)

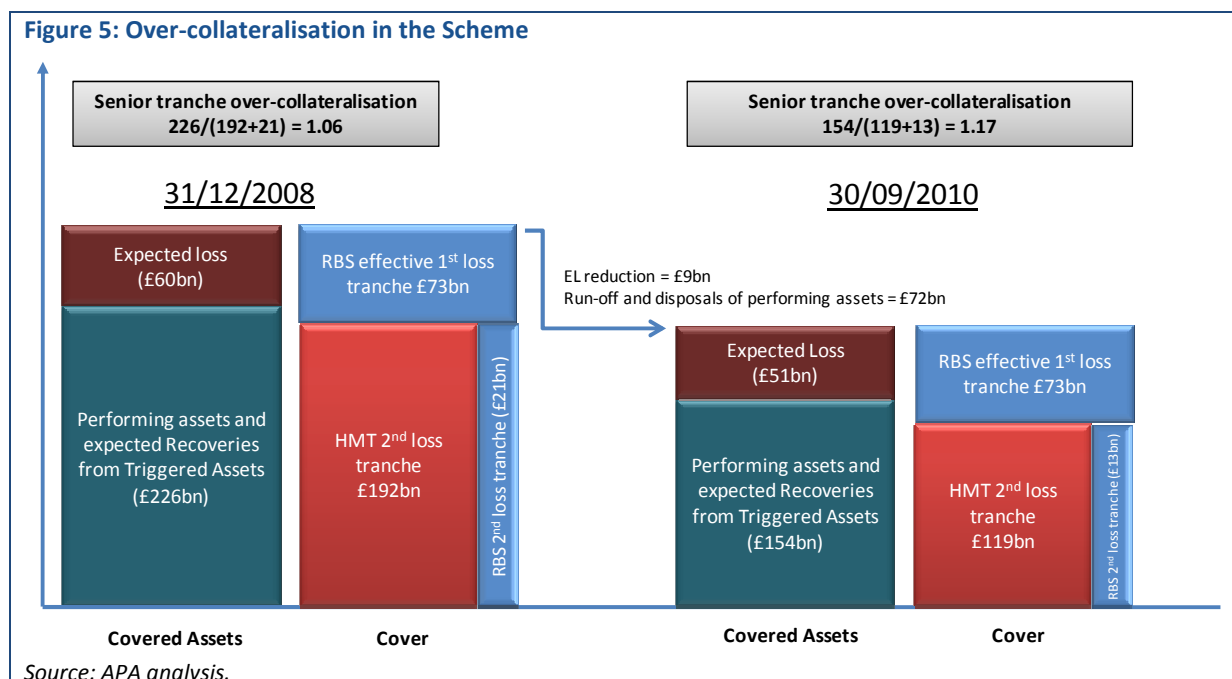
	Triggered Amount (£bn)	Recoveries	Expected Loss as at 30 September 2010	Expected Loss in per cent of Triggered Amount
Triggered Assets	42	13	28	68%
Non-Triggered Assets	37	15	22	60%
Loss Credits	0.7	0	0.7	100%
Total	79	28	51	65%

Source: APA analysis.

HMT benefits from substantial over-collateralisation in the Scheme. The first layer of over-collateralisation is provided by the first loss amount of £60bn. The second layer is due to the fact that RBS is required to pay a £500m annual fee to remain in the Scheme.¹ Only if losses are over approximately £73bn will the value of the Scheme payments be greater than the fees, and so only at that level would RBS rationally stay in and an ultimate payout be made.

The degree of over-collateralisation can be measured as the amount by which the expected value of performing assets and expected Recoveries exceed the size of the second loss tranche as illustrated in Figure 5 below. Since the Scheme's inception to 30 September 2010, the degree of over-collateralisation has increased from 6 to 17 per cent.

Figure 5: Over-collateralisation in the Scheme

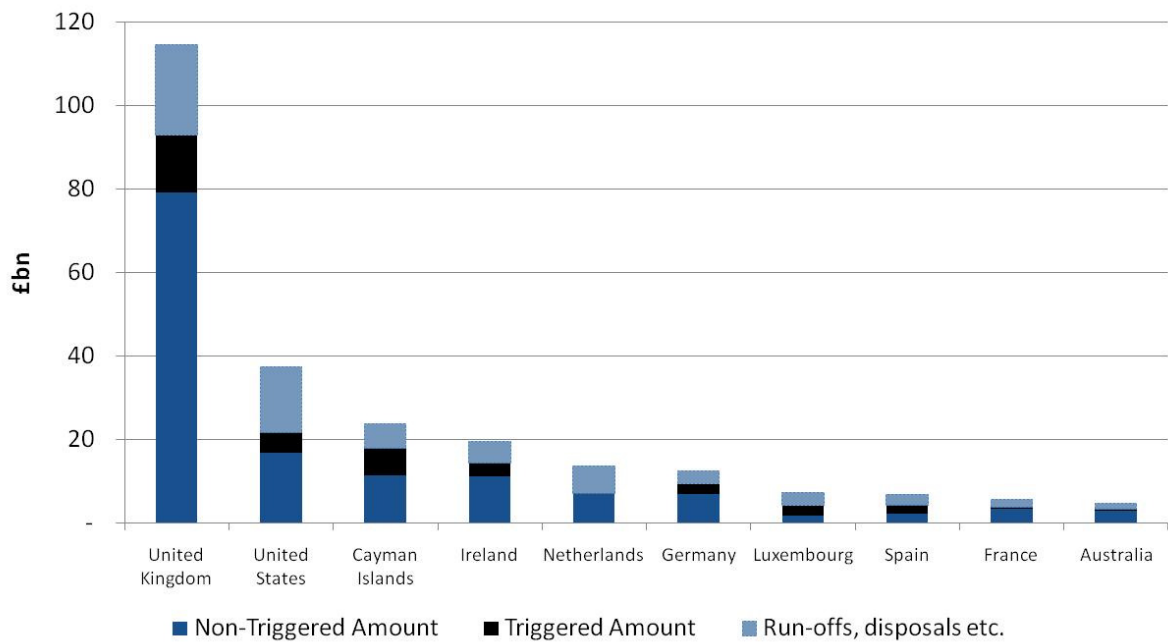


Since the publication of the APA's 2009/10 Annual Report and Accounts there has been significant focus on sovereign risk with pressure on a number of Euro-zone countries. Figure 6 below shows the top ten countries by initial Covered Amount as at 31 December 2008, and how that breaks down

¹ If RBS exits the Scheme, any payouts received by RBS must be paid back to HMT with interest.

into currently non-Triggered Amount, Triggered Amount and cover that has run-off or has expired due to disposals or withdrawals from the Scheme.

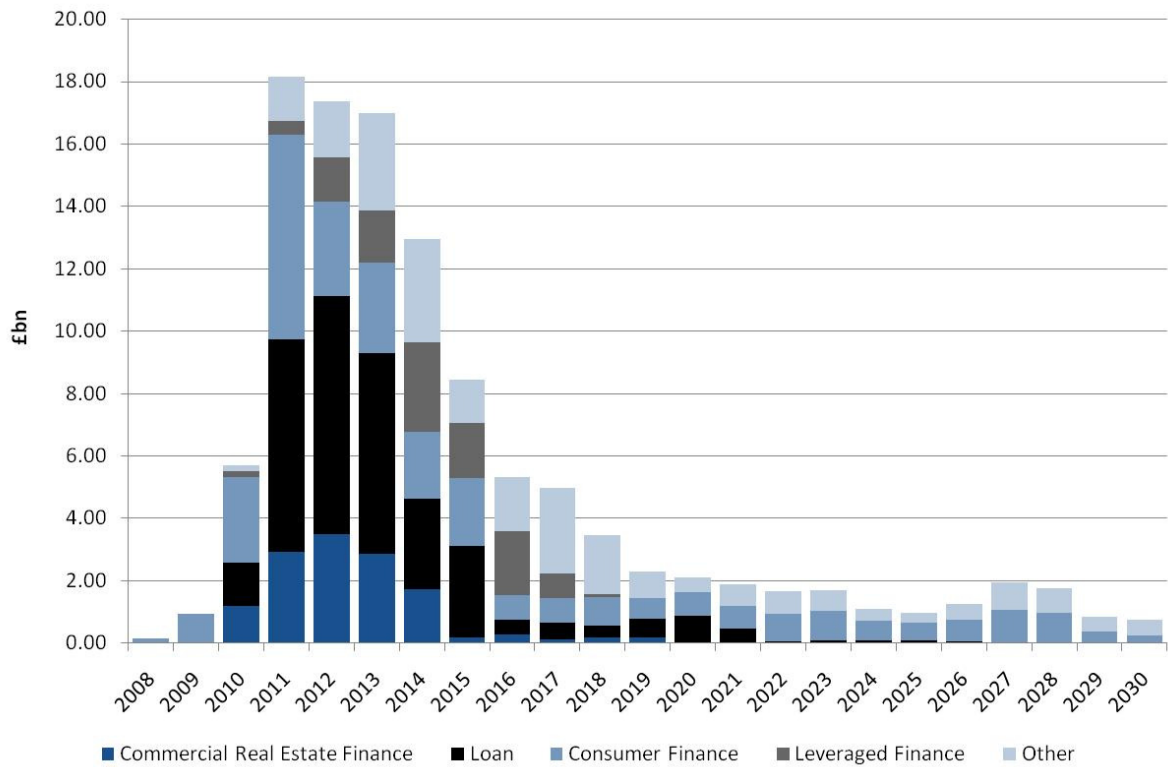
Figure 6: Top ten countries by initial Covered Amount



Source: APA analysis.

Some of the APS portfolio will require re-financing. The peak is expected to occur in the period 2011-2013. Figure 7 below shows the original maturity profile of Non-Triggered Assets as at 30 September 2010. RBS will dispose of some of these assets. Others will re-finance under normal commercial terms with RBS or other lenders. The remainder will either become Triggered Assets or RBS may decide to maintain exposure by re-financing existing loans on terms less favourable than new business. Should RBS decide to do the latter APS cover will lapse.

Figure 7: Maturity profile of non-Triggered Assets²



Source: APA analysis

Table 3 below shows the results of sensitivity tests that the APA has carried out on 30 September 2010 portfolio data and compares it with similar sensitivity tests that the APA prepared on portfolio data nine months prior. The sensitivities have gone down in line with the lower Expected Loss forecast and the reduction in Covered Amount.

In addition to single factor stresses and a macroeconomic stress test, the APA has also prepared a “reverse stress test” which shows what stress levels in terms of rating migrations, recoveries, and macro-factors would be required for losses to exceed approximately £73bn, the point at which HMT may incur a loss under the Scheme. The application of 1920-1940’s default rates, adverse commercial real estate prices and 37 per cent less Recoveries was sufficient to result in a loss to HMT when a similar analysis based on 31 December 2009 portfolio data was prepared for the APA’s 2009/10 Annual Report and Accounts. Based on 30 September 2010 portfolio data, Recoveries would have to be reduced by more than 60 per cent to achieve the same level of losses.

² Figure 7 shows Covered Amount (as at 30 September 2010) of non-amortising Non-Triggered assets scheduled to mature in each year. Actual amounts maturing will differ due to Triggers prior to maturity, voluntary prepayment, undrawn amounts, and asset disposal prior to maturity.

Table 3: Sensitivity and reverse stress-testing

Type	Description	Expected Loss (£bn) 31 December 2009	Expected Loss (£bn) 30 September 2010	
Base scenario	APA's best estimate based on current economic outlook	57	51	
Sensitivity	1. Occurrence of immediate Triggers of entire leveraged finance and structured credit portfolios	70	69	
	2. FX sensitivity	Appreciation by 25%	53	48
		Depreciation by 25%	65	56
	3. CRE price sensitivity	Increase by 25%	52	48
		Decrease by 25%	59	56
	4. Reduced Recoveries	Decrease by 5%	59	52
		Decrease by 10%	61	54
		Decrease by 15%	62	55
		Decrease by 20%	64	57
		Decrease by 25%	66	58
Reverse stress testing	5. Severe stress Moody's Cumulative Default Rates for 1920-1940 Downturn in UK CRE prices Recoveries are 37 per cent lower than expected	74	66	
	6. Severe stress Moody's Cumulative Default Rates for 1920-1940 Downturn in UK CRE prices Recoveries are 63 per cent lower than expected	83	74	

Source: APA analysis

A.2.2. Awarding of Loss Credits on disposal of assets

When RBS disposes of Non-Triggered Assets it is not entitled to compensation for any discount to par that it may incur as a result of the sale as the Scheme covers only principal losses on Triggered Assets. To ensure RBS incentives to de-risk the APS portfolio are not reduced by the existence of the Scheme, a Loss Credit is generally awarded on the disposal of Non-Triggered Assets. A Loss Credit is a measure of the expectation of the Net Loss that would have been incurred on the asset had it remained within the Scheme.

Withdrawal of a Non-Triggered Asset reduces the total number of assets in the Scheme and thereby reduces the level of potential Losses covered by the Scheme. If no Loss Credits were awarded, RBS would therefore extract less benefit from the Scheme as assets were removed, but its payments for being in the Scheme would remain unchanged; this could discourage RBS from selling assets covered by the Scheme. The award of a Loss Credit redresses the balance and ensures that RBS gains at least some of the benefit it would have had if it retained the asset within the Scheme while de-risking of the Scheme and the bank overall.

At 30 September 2010 Loss Credits had been awarded to a value of £0.7bn on £2.2bn of Covered Assets. During the last quarter of 2010 further Loss Credits of £0.5bn were awarded. There is a pipeline of recent and planned sales by RBS which is likely to lead to awards of further Loss Credits. If RBS meets the targets in its business plan for the rundown of its non-core business and HMT continues to award Loss Credits, it is likely that a significant amount of Loss Credits will be awarded in 2011.

A.2.3. APS valuation for HMT's Annual Report and Accounts

The APA is also responsible for the valuation of the APS for inclusion in HMT's Annual Report and Accounts. In accordance with IFRS, the APS is marked-to-market, with the result reflecting credit spreads, exchange rates, interest rates, and the quality of the underlying portfolio.

Table 4 below compares the previously published and current fair values as determined by the APA to the comparable values published by RBS. The difference as at 31 March 2010 was primarily due to a difference in the timing of recognition of certain value changes. The two valuations have since converged considerably, though minor differences in recognition remain. Broader testing has shown that the two valuations are not generally very sensitive to other minor differences in modelling assumptions.

Table 4: APS valuation since last published accounts

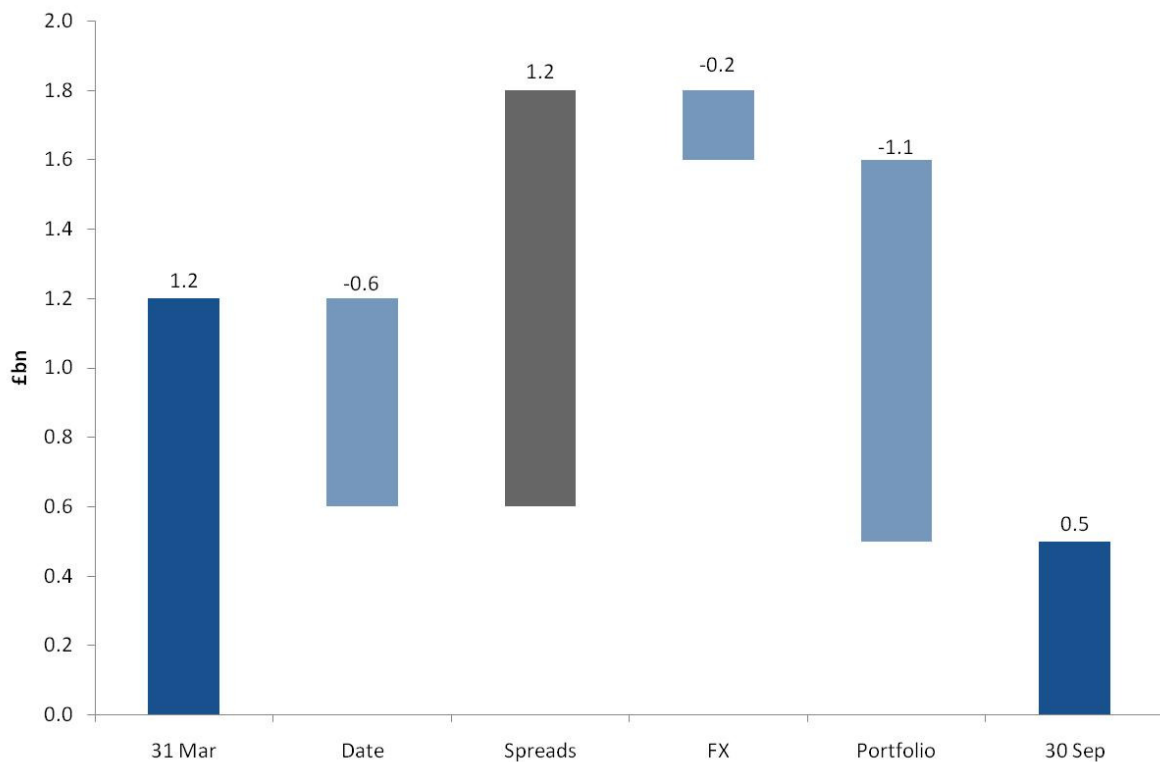
Date	APA valuation (£m liability)	RBS valuation (£m asset)
31 March	1,200	900
30 September	500	575

Source: APA analysis.

As at 30 September 2010, the fair value of the APS is a £0.5bn liability to HMT, though different assumptions as to the value of unobservable inputs could lead to a result that is higher or lower by £1.6bn. This is a mark-to-market profit to HMT of £0.9bn since inception, £0.7bn since 31 March 2010. Figure 8 below summarises the drivers of that change in value since 31 March 2010.

- The 'Date' effect includes the maturing of some assets over the period, the shortened remaining cover and so lower probability of Trigger on others, and reduced option value.
- The 'Spreads' effect is due to the widening of credit spreads over the period and includes a small effect from movement in the risk-free rate.
- The 'FX' effect is due to the change in sterling exposure on Covered Assets denominated in foreign currencies, primarily driven by a slight weakening against USD partially offset by a slight strengthening against EUR.
- The 'Portfolio' effect includes Probability of Default and Loss Given Default migration, amortisation of Covered Amount, changes in Outstanding Amount of non-credit derivatives, withdrawal of assets, and Loss Credits.

Figure 8: Attribution of P&L since 31 March 2010 (£bn)



Source: APA analysis

The valuation can be thought of in the context of amortising the cash payments from RBS. The fair value of the APS liability is the value of the protection less the value of the remaining fee payments. Payments are currently annual and frontloaded, although the APA has agreed with RBS to move to quarterly payments to ease RBS's exit from the Scheme. The APS liability increases as those payments are received and the value of remaining payments is reduced, but no profit is recognised at that time. Profits are recognised only as the value of the protection decreases. The central expectation is that the value of the protection will decrease smoothly through time, though even in this case, there will be jumps in the derivative valuation as fees are paid. Volatility around that central path reflects changing evaluations of the likelihood of payout. While total fees and point of exit remain subject to considerable uncertainty, the current valuation is reasonably consistent with the expectation of no payout by HMT and an exit by RBS at or near the point of having paid the minimum fee.

A.3 Chief Financial and Operations Officer's review

The Finance and Operations team is responsible for the oversight of data reported under the Scheme, Scheme Ledger reporting, IT and other infrastructure, and the APA's finance and HR function.

As at 31 December 2010, the Finance and Operations team comprised 14 staff.

A.3.1. Data management and validation

Delivery of data from RBS to the APA moved to regular monthly cycles from August 2010 and this coincided with the successful release of the APA's data management IT system (TAPAS) which has automated much of the data validation activity. We continue to generate exception reports that are shared with RBS and form the basis of discussions where follow-up is required. The automation provided by TAPAS significantly reduces the time required to approve the data for release to the Investment Management, Finance and Risk teams and allows them to complete their different models and reports. As well as automation of the validation testing, the TAPAS system also allows users to interrogate a data warehouse holding all the Post-Accession and Quarterly Statement Data submissions received from RBS during the lifetime of the Scheme.

Regular meetings between the APA validation team and their RBS counterparts provide a forum for RBS to explain the exceptions reported and allow both parties to agree how anomalies are to be addressed. These meetings continue to be constructive and the overall quality of the data shows an improving trend.

A.3.2. Verification

Verification forms part of the APA's 'toolkit' to provide assurance over RBS's compliance with the terms and conditions of its participation in the Scheme and includes accurate, valid and appropriate loss verification over the life of the APS. Verification data testing evidence is evaluated by APA management together with the findings of the APA data validation team and other assurance procedures performed by the APA, such as the review of the assurance activities performed by RBS.

PricewaterhouseCoopers, the APA's appointed independent verification agent, has completed a work programme as set out in the initial six month plan for verification that was tabled at the Audit and Risk Committee meeting in May 2010. The work performed included testing reported losses for a selection of assets and enabled APA management to establish a verification strategy and plan for the remainder of 2010/11. Verification will follow a risk-based asset selection approach with a core data testing programme that focuses on the data fields that are most important for the APS financial instrument valuation and the expected loss forecast. The core verification programme is supplemented through ad-hoc reviews into specific areas of interest to the APA. The APA leverages the activities of RBS' Group Internal Audit function to achieve an efficient and effective approach.

Annex B: Overview of Covered Assets

The information set out in Tables 5 to 9 below, including the notes to those tables, has been extracted from information published by RBSG as specified therein. This information has not been independently verified by or on behalf of the APA and is therefore not determinative of any payouts that HMT may be required to make under the Scheme.

RBS included assets in the Scheme with a total par value as at 31 December 2008 of £282bn. The Covered Assets were generally selected in terms of adverse credit quality as reflected by high Probability of Default and high Loss Given Default. Table 5 below summarises the criteria applied by RBS during 2009 for identifying candidate assets for inclusion in the APS.

Table 5: Selection of the APS portfolio

Contributing divisions ⁽¹⁾	Selection criteria
UK Retail	<ul style="list-style-type: none"> ▪ Mortgages: assets with a higher loan-to-value (LTV) and in higher risk segments (e.g. LTV >97% on general book, LTV >85% on buy-to-let book), and those assets in arrears (at 31 December 2008). ▪ Loans and overdrafts: higher risk customers based on internal bandings, and those assets in arrears (at 31 December 2008).
UK Corporate	<ul style="list-style-type: none"> ▪ Commercial & corporate real estate: all defaulted assets in the work-out/restructuring unit, and those assets in high risk bands. ▪ Corporate: all defaulted assets in the work-out/restructuring unit. Corporate banking clients in high risk sectors or with high concentration risk. ▪ Business Banking: portfolios in the work out/restructuring unit and those in high risk bands.
Global Banking & Markets	<ul style="list-style-type: none"> ▪ Banking book: selection by individual assets (corporate loans, real estate finance, and leveraged finance), Global Restructuring Group work-out unit counterparties/assets and high risk counterparties/assets. ▪ Additional counterparties/assets were selected through an individual risk review of the total portfolio. ▪ Trading book: selection by individual assets (monolines, derivatives, mortgage trading).
Ulster Bank (Corporate and Retail)	<ul style="list-style-type: none"> ▪ Mortgages: assets with greater than 85% LTV, broker mortgages and interest only with a higher Probability of Default. ▪ Retail: portfolios of accounts in default, >1 month arrears, <2 years old and a higher Probability of Default. ▪ Corporate: counterparties/assets in work-out/restructuring groups or in high risk bands, and other assets identified as part of an individual review of cases.

Note: (1) Including assets transferred to Non-Core Division

Source: RBSG Annual Report 2009, page 175

Table 6 below details the movement in Covered Assets between 31 December 2009 and 30 September 2010.

Table 6: Covered Assets

Changes to Covered Assets	£ bn
Covered Assets at 31 December 2009	230.5
Disposals	(3.2)
Re-classified assets	3.1
Maturities, amortisation and early repayments	(13.1)
Withdrawn assets	(2.9)
Effect of foreign currency movements and other adjustments	1.1
Covered Assets at 30 June 2010⁽¹⁾	215.5
Disposals	(3.5)
Maturities, repayments, amortisations and early repayments	(7.3)
Effect of foreign currency movements and other adjustments	0.7
Covered Assets at 30 September 2010	205.4

Source: RBSG Interim Results 2010, Appendix 3, page 1 and RBSG Q3 2010 Interim Management Statement, Appendix 2, page 2

Table 7 below summarises the total Triggered Amount and related Recoveries by division as at 30 September 2010 and compares it to credit impairments and write-downs for the same divisions. The Non-Core division is the operating division of the RBS Group that manages separately the assets that the RBS Group intends to run off or dispose of.

Table 7: Triggered Amount, Recoveries and impairments as at 30 September 2010 (£m)

Contributing Divisions	Triggered Amount	Recoveries	Net Triggered Amount	Credit Impairments and Write Downs
UK Retail	3,613	371	3,242	2,880
UK Corporate	4,027	1,032	2,992	1,026
GBM	3,057	464	2,593	1,769
Ulster Bank (Corporate and Retail)	1,387	109	1,278	697
Non-Core	29,502	2,888	26,614	25,442
Total at 30 September 2010	41,586	4,864	36,722	31,814

Note: (1) The triggered amount on a Covered Asset is calculated when an asset is triggered (due to bankruptcy, failure to pay after a grace period, and restructuring after an impairment) and is the lower of the Covered Amount and the Outstanding Amount for each Covered Asset. Given the grace period for triggering assets, the Group expects additional assets to trigger based on the current risk rating and level of impairments on Covered Assets.

Source: RBSG Q32010 Interim Management Statement, Appendix 2, pages 3-4

Table 8 below sets out cumulative credit impairment losses (including available-for-sale reserves) and adjustments to par value relating to Covered Assets at 30 June 2010 and 30 September 2010.

Table 8: Cumulative credit impairment losses (£m)

	30 September 2010	30 June 2010
Loans and advances	17,360	16,702
Debt securities	12,113	13,980
Derivatives	2,341	1,828
	31,814	32,510
By division		
UK Retail	2,880	2,765
UK Corporate	1,026	927
GBM	1,769	1,528
Ulster Bank	697	730
Non-Core	25,442	26,560
	31,814	32,510

Source: RBSG Q32010 Interim Management Statement, Appendix 2, page 3

Table 9 below details the total Triggered Amount by division at 30 June 2010 and 30 September 2010. These exclude Recoveries.

Table 9: Total Triggered Amount by division (£m)

	30 September 2010	30 June 2010
UK Retail	3,613	3,503
UK Corporate	4,027	3,431
GBM	3,057	2,579
Ulster Bank	1,387	917
Non-Core	29,502	26,590
	41,586	37,020

*Notes: (1) The Triggered Amount on a Covered Asset is calculated when an asset is Triggered and is the lower of the Covered Amount on the Initial Event Date and the Outstanding Amount on the Trigger Date for each Covered Asset.
Source: RBSG Q32010 Interim Management Statement, Appendix 2, page 4*

Annex C: Glossary of Terms

Abbreviations

AMO	Asset Management Objective
APA	Asset Protection Agency
APS	Asset Protection Scheme
CRE	Commercial Real Estate
EUR	Euro
FSA	Financial Services Authority
FX	Foreign Exchange
GBM	Global Banking Markets (a division of RBS)
GDP	Gross Domestic Product
HMT	Her Majesty's Treasury
IFRS	International Financial Reporting Standards
LTV	Loan-to-Value
NPV	Net Present Value
RBS	The Royal Bank of Scotland plc
RBSG	The Royal Bank of Scotland Group plc
RWA	Risk Weighted Asset
SOC	Senior Oversight Committee
USD	United States' Dollar

Definitions

Capitalised expressions used in this document that are not otherwise defined have the same meanings as in the legal documents that set out the terms of RBS's participation in the Asset Protection Scheme. These documents, which include the terms and conditions of the APS (the "Conditions"), have been published on HMT's website at http://www.hm-treasury.gov.uk/financial_stability_agreements.htm

In addition, the following capitalised expressions have the meanings ascribed to them as below:

Expected Loss	means the estimated life-time Net Loss of the Covered Assets
Loss Credit	means the benefit, if any, which the APA agrees to make available to RBS as a result of a disposal of a Non-Triggered Asset
Net Losses	means, at any date, Losses less Recoveries at that date
Net Triggered Amount	has the same meaning as Net Losses
Triggered Amount	has the same meaning as Losses.

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